Yardeni Research, Inc.

MORNING BRIEFING
May 22, 2017

Where Is This Leading?

See the pdf and the collection of the individual charts linked below.

(1) The latest panic attack lasted one day. (2) Keeping a diary of anxiety attacks. (3) VIX taking regular doses of Valium to stay calm. (4) Pills for the President. (5) One monthly and two weekly LEIs all at record highs. (6) CEI benchmark model sees next recession starting March 2019. (7) CEI confirming 2% trend growth in real GDP. (8) Resource Utilization Rate and LEI/CEI ratio are bullish for profit margin. (9) Yield curve signaling neither boom nor bust. (10) NY & Philly Fed surveys showing animal spirits remain spirited.

Strategy I: Vix on Valium. Joe and I long have characterized the current bull market as a series of panic attacks followed by relief rallies to new cyclical highs and then to new record highs since March 28, 2013. We are adding the 1.8% drop in the S&P 500 last Wednesday to our list of panic attacks even though it only lasted one day (so far). It was triggered by a wave of hysteria about the possibility of President Trump getting impeached for obstructing justice in the matter of Michael Flynn. We've been keeping track of the anxiety attacks since the start of the bull market in our chart publication titled *S&P 500 Panic Attacks Since 2009*.

We now count 56 of them. Of this total, four were "official" corrections, with the S&P 500 down between 10% and 20%, and six were mini-corrections, registering declines of 5%-10% on the panic spectrum (*Fig. 1*). We haven't attempted to predict when these bouts might occur, but we've viewed them all as buying opportunities. We remain on the lookout for a bear market, which most likely would be caused by a recession. However, we don't see either calamity anytime soon, as confirmed by our analysis of the leading indicators below.

Another way to identify panic attacks is by tracking the S&P 500 VIX, which is widely known as the "fear index" (*Fig. 2*). On this basis, the Trump scare is minor, with the VIX rising to just 15.59 on Wednesday. It spiked to 22.51 just before last year's election on concerns that the FBI was coming after Hillary Clinton again. Before that, it spiked to 25.76 in late June on Brexit, which was just a two-day selloff.

It was relatively easy to panic investors following the Trauma of 2008. It's been almost nine years since then. Time heals all wounds, as long as they aren't fatal ones. Following the fiscal-cliff nonevent at the start of 2013, I wrote that investors might be getting "anxiety fatigue." They seem to be less panic-prone, as evidenced by the shortness of the most recent attacks.

I'm thinking of applying for a permit to practice psychiatry so I can prescribe Valium for our accounts if they get too jittery. Someone needs to get some pills for the President. He really needs to calm down and tone it down.

Strategy II: Looking Up. While the headlines continue to be all about the swamp people in Washington on a 24/7 basis, the Index of Leading Economic Indicators (LEI) continues to climb to new record highs, and so does the Index of Coincident Economic Indicators (CEI) (*Fig. 3*). That news came out last Thursday, but it certainly didn't make the front pages. Debbie and I aren't surprised by the news because our YRI Weekly Leading Indicator continued to soar into record-high territory through early May, as it has been doing since early last year (*Fig. 4*). The same can be said about the Weekly Leading Index compiled by the Economic Cycle Research Institute (*Fig. 5*).

Joe and I aren't surprised because the weekly S&P 500 forward earnings is also highly correlated with the LEI (*Fig. 6*). The former has been climbing rapidly into record territory since March 10, once the energy-led earnings recession ended and stopped weighing on earnings. The weekly S&P 500 forward revenues series has also been climbing to new highs. Let's take a dive into the wonderful world of the leading and coincident economic indicators:

(1) *LEI/CEI.* Debbie and I also track the ratio of the LEI to the CEI (*Fig. 7*). It's actually a useful leading indicator that is mostly cyclical without the uptrend of the LEI. It rose to 1.102 during April, the highest since November 2007, but remains below all the previous cyclical peaks since 1959. This could be a harbinger of a longer-than-average economic expansion.

(2) *CEI.* Also auguring for a long economic expansion is our analysis of the past five cycles in the CEI (*Fig. 8*). We've previously noted that the expansion phases, following the recovery phases back to the previous peak, lasted 65 months on average. That would put this cycle's peak in March 2019. This isn't a model but rather a benchmark based on recent history. Given our view that inflation is likely to remain subdued with Fed policy raising interest rates very gradually, we remain in the lower-growth-for-longer camp.

(3) *GDP.* The CEI and LEI are designed to time the peak and troughs of the business cycle, not the growth rate of real GDP. However, we've found that the y/y percent change in the CEI tracks the comparable growth in real GDP quite closely (*Fig. 9*). The former was up 2.0% during April. It has been fluctuating around this level since mid-2010, which is the same story for real GDP.

The yearly growth rate in the LEI has a much greater cyclical amplitude than the growth in real GDP (*Fig. 10*). However, it can be used to gauge whether the underlying economic momentum is rising or falling. It has been improving in recent months.

(4*) Resource utilization.* The LEI/CEI ratio is a leading indicator of the Resource Utilization Rate (RUR) (*Fig. 11*). We construct RUR by averaging the capacity utilization rate and the employment rate, which is 100 minus the unemployment rate (*Fig. 12*). Both measures confirm that the expansion is maturing. However, both also remain below previous cyclical peaks.

(5) *Profit margin.* The recent upturns in the LEI/CEI and RUR are good signs for corporate profit margins (*Fig. 13* and *Fig. 14*).

(6) *Yield curve.* There are three financial components among the 10 components of the LEI. The S&P 500 is one of them. The other two are the yield-curve spread between the US Treasury 10-year bond yield and the federal funds rate, and the Leading Credit Index, which the Conference Board compiles using six different financial indicators (*Fig. 15* and *Fig. 16*). It tends to spike prior to and during recessions. It doesn't do much in between the spikes. It actually seems to be more of a coincident indicator, in our opinion.

The yield-curve spread, on the other hand, has a long history of accurately predicting recessions when it turns negative. As long as it remains positive, all should be well. However, if it is falling toward zero, it certainly should get our attention. Currently, there isn't much to worry about. However, there is some concern that after the spread's Trump-bump widening from 136bps during October to a recent peak of 195bps during December, it was back down to 140bps during April.

Of course, while the LEI uses the monthly yield-curve spread, it is also available daily. It was 147bps on Election Day, rising to 213bps on December 14 and falling back down to 132bps on Friday.

(7) *Regional surveys.* Below, Debbie reviews the regional business surveys conducted by the NY and Philly Feds. She reports that the average of their composite indexes dipped from a recent high of 31.0 during February to 18.9 during May, though that was up from April's 13.6. That's still well above last October's 2.8 average, before the November 8 election results boosted animal spirits.

CALENDARS

US. Mon: Chicago Fed National Activity Index 0.10, Kashkari, Harker, Brainard, Evans. **Tues:** New Home Sales 604k, Richmond Fed Manufacturing Index 15, Kashkari, Brainard. (Bloomberg estimates)

Global. Mon: Germany GDP 0.6%q/q/1.7%y/y (wda). **Tues:** Eurozone, Germany, and France Composite PMI Flash Estimates 56.7/56.6/56.6, Eurozone, Germany, and France M-PMI Flash Estimates 56.5/58.0/55.2, Eurozone, Germany, and France NM-PMI Flash Estimates 56.4/55.5/56.7, Germany Ifo Business Climate, Current Assessment, and Expectations Indexes 121.0/113.1/105.4. (DailyFX estimates)

STRATEGY INDICATORS

Global Stock Markets Performance (*link*): The US MSCI index fell 0.4% last week, ranking 37th of the 49 markets as 30 rose in US dollar terms—compared to 34th a week earlier, when it fell 0.4% as 29 markets moved higher. The AC World ex-US index outperformed the US MSCI, rising 0.4% compared to a 0.6% gain a week earlier. EMU was the best-performing region last week with a gain of 1.3%, followed by EAFE (0.8%). EM Latin America was the week's worst-performing region, with a decline of 7.4%, followed by BRIC (-1.6), EMEA (-0.1), EM Eastern Europe (0.0), and EM Asia (0.3). Austria (8.0) was the best-performing country, followed by Hungary (5.2), Norway (3.1), Italy (2.6), and Czech Republic (2.4). Brazil (-12.5) was the worst performer, followed by Pakistan (-3.9), Egypt (-1.7), and Israel (-1.7). The US MSCI is up 6.5% ytd, with its ranking unchanged w/w at 38/49, but continues to trail the AC World ex-US (11.8) on a ytd basis. Forty-six of the 49 markets are positive ytd, led by Argentina (41.5), Poland (32.9), Austria (30.6), Korea (24.1), Spain (23.7), and Greece (23.7). The worst country performers ytd: Russia (-8.0), Jordan (-1.4), Canada (-0.3), New Zealand (0.2), and Morocco (0.8). EM Asia is the best-performing region ytd with a gain of 18.8%, ahead of: EMU (16.9), BRIC (14.2), and EAFE (11.8). The worst-performing regions, albeit with gains: EM Eastern Europe (1.5), EMEA (4.1), and EM Latin America (7.6).

S&P 1500/500/400/600 Performance (*link*): LargeCap and MidCap fell for a second week, and SmallCap dropped for a third week. LargeCap's decline of 0.4% was a tad less than MidCap's 0.4% drop as SmallCap fell 1.2%. Ten of the 33 sectors rose, up from eight rising a week earlier. LargeCap ended the week 0.9% below its Monday record high, MidCap was 2.6% below its March 1 record, and SmallCap ended 4.1% below its record high on February 21. Last week's top gainers: MidCap Telecom (7.4%), MidCap Energy (2.1), SmallCap Real Estate (1.4). LargeCap Real Estate (1.2), and SmallCap Energy (1.2). Last week's worst performers: SmallCap Telecom (-2.2), SmallCap Health Care (-2.0), MidCap Consumer Discretionary (-1.9), SmallCap Consumer Discretionary (-1.7), and SmallCap Tech (-1.6). Eighteen of the 33 sectors are positive ytd, with LargeCap (6.4) beating MidCap (3.1) and both easily ahead of SmallCap (-1.2). The biggest sector gainers ytd: LargeCap Tech (16.9), MidCap Health Care (14.9), SmallCap Health Care (11.1), MidCap Tech (10.5), and LargeCap Consumer Discretionary (9.5). Energy and Telecom dominate the worst performers ytd: MidCap Telecom (-27.5), SmallCap Energy (-26.6), MidCap Energy (-20.3), LargeCap Telecom (-11.4), and LargeCap Energy (-10.2).

S&P 500 Sectors and Industries Performance (*link*): Four of the 11 sectors rose last week, and six outperformed the S&P 500's 0.4% decline. This compares to two sectors rising a week earlier, when

3

four outperformed the S&P 500's 0.3% decline. Real Estate was the best-performing sector with a gain of 1.2%, its best in nine weeks and followed by Consumer Staples (0.6%), Utilities (0.5), Energy (0.2), Industrials (-0.2), and Health Care (-0.4). Telecom fell for a ninth week. Last week's worst performers: Financials (-1.0), Consumer Discretionary (-0.8), Tech (-0.7), Telecom (-0.7), and Materials (-0.4). So far in 2017, eight of the 11 sectors are higher, and five have outperformed the S&P 500's 6.4% gain. The best performers in 2017 to date: Tech (16.9), Consumer Discretionary (9.5), Health Care (8.6), Consumer Staples (6.7), and Utilities (6.6). The six sectors underperforming the S&P 500: Telecom (-11.4), Energy (-10.2), Financials (0.0), Real Estate (2.9), Materials (5.2), and Industrials (5.2).

Commodities Performance (*link*): Sixteen of the 24 commodities we follow rose last week, up from 14 rising a week earlier. Energy-related commodities dominated the week's best performers: Heating Oil (5.9%), Sugar (5.6), GasOil (5.4), Brent Crude (5.3), Crude Oil (5.2), and Unleaded Gasoline (4.7). Last week's laggards: Natural Gas (-4.1), Cotton (-3.3), Coffee (-2.1), and Lead (-1.6). The best performers in 2017 so far: Lean Hogs (21.2), Feeder Cattle (20.3), Aluminum (14.8), and Cotton (12.5). The energy-related commodities are no longer dominating this year's laggards: Sugar (-16.0), Natural Gas (-10.0), Heating Oil (-8.1), Nickel (-6.5), and GasOil (-6.2).

Assets Sorted by Spread w/ 200-dmas (*link*): Spreads between prices and 200-day moving averages (200-dmas) rose last week for 16/24 commodities, 3/9 global stock indexes, and 9/33 US stock indexes compared to 13/24, 4/9, and 6/33 rising a week earlier, respectively. Seventeen commodities trade above their 200-dmas, up from 11 a week earlier as these six turned positive w/w: Brent Crude, Crude Oil, Gold, Heating Oil, GasOil, and Zinc. Commodities' average spread rose to 1.9% from 0.7%. Among assets, Commodities walked away the top two spots last week: Lean Hogs leads all commodities and all assets at 27.7% above its 200-dma, followed by Feeder Cattle (16.2%) and Aluminum (9.3). Sugar (-16.7), Cocoa (-13.0), and Coffee (-10.1) trade at the lowest of the commodity assets relative to their 200-dmas. Heating Oil performed the best of all commodities assets last week, improving 5.4ppts to 1.5%. Natural Gas was the worst performer of all commodities last week, tumbling 5.2ppts to 6.4%. The global indexes trade at an average of 6.0% above their 200-dmas, down from 7.4% above in the prior week. All nine of the global indexes trade above their 200-dmas, unchanged from a week earlier. Germany (11.2) leads the global indexes, but Indonesia (7.3) was the group's best performer last week with a 2.0ppts advance. Brazil (0.1) is trading at the lowest relative to its 200-dma of the global assets, and had the weakest performance of its country peers and all assets last week, falling 9.3ppts. The US indexes trade at an average of 1.5% above their 200-dmas, with 24 of the 33 sectors above, down from a 2.0% average a week earlier, when 24 sectors were above. SmallCap Materials and Telecom both turned negative w/w, and SmallCap Real Estate and LargeCap Real Estate both turned positive. The US stock indexes no longer dominate the top ten assets trading above their 200-dmas as they did in early March. LargeCap Tech leads all US stock indexes at 12.2% above its 200-dma, followed by MidCap Health Care (10.9) and MidCap Tech (10.1). SmallCap Health Care (8.2) fell 2.6ppts w/w for the biggest decline among US stock indexes. MidCap Telecom trades 22.2% below its 200-dma, the lowest among the US stock indexes and all assets, but soared 6.0ppts w/w for the best performance of all assets.

S&P 500 Technical Indicators (*link*): The S&P 500 index remained in a Golden Cross last week for a 56th week (after 17 weeks in a Death Cross). However, the index's 50-day moving average (50-dma) relative to its 200-dma fell for an eighth week after rising since early December. Its 50-dma was 4.8% above its 200-dma, down from 5.0% a week earlier and a 34-month high of nearly 5.5% in early April. That's up from a six-month low of 2.0% in early December and a 52-month low of -4.5% in March 2016. The S&P 500's 50-dma moved higher for a 27th week as the index closed above its 50-dma for a fourth week, after two weeks below, for the first time since the November election. The S&P 500 fell to 0.5% above its rising 50-dma from 1.1% a week earlier, but is up from a 23-week low of -1.0% in mid-April. That's down from a 38-week high of 4.8% above its rising 50-dma on December 13 and compares to a

52-month high of 6.2% in March 2016 and a five-month low of -7.8% in January 2016. The S&P 500 weakened to 5.4% above its rising 200-dma last week from 6.0% a week earlier, but remains above mid-April's 19-week low of 4.2%. That's down from a 38-month high of 9.4% on March 1. The 50-dma and 200-dma both rose together for a 25th week, but at a slower pace than in recent weeks.

S&P 500 Sectors Technical Indicators (*link*): Five of the 11 sectors improved w/w relative to their 50-dmas, and these three also rose relative to their 200-dmas: Consumer Staples, Materials, and Utilities. Seven of the 11 sectors trade above their 50-day moving averages (50-dmas), up from six a week earlier and up from three in mid-April, which was the lowest since the election. Energy remained below for an 18th straight week, and Financials and Telecom were below for a ninth week. Real Estate and Consumer Staples turned positive w/w, and Materials turned negative for the first time in four weeks. All 11 sectors had been above their 50-dmas during mid-January, and all 11 were below the week before the election, for the first time since December 11, 2015. Nine of the 11 sectors were above their 200-dmas last week, unchanged from a week earlier, as Energy remained below its 200-dma for a 13th week and Telecom for a ninth. Nine sectors are in a Golden Cross, with 50-dmas higher than their 200-dmas, unchanged from a week earlier and leaving Energy and Telecom still out of the club. All 11 had been in a Golden Cross during a 21-week streak that ended October 24, the longest such stretch since October 2014. Six of the 11 sectors have rising 50-dmas, up from five a week earlier. Consumer Staples, Real Estate, and Utilities turned up; Materials turned flat, and Health Care turned down. Financials' 50-dma fell for an eighth week; Energy's dropped for a 16th week; and Telecom's fell for a 15th. Eight sectors have rising 200-dmas, up from six a week earlier, as Consumer Staples and Energy began rising. Three sectors continued downtrends: Real Estate's 200-dma fell for an 11th week, Telecom's for a ninth, and Utilities' for a third.

US ECONOMIC INDICATORS

Leading Indicators (*link*): "The recent trend in the U.S. LEI, led by the positive outlook of consumers and financial markets, continues to point to a growing economy, perhaps even a cyclical pickup," according to the Conference Board. The Leading Indicators Index (LEI) advanced for the eighth straight month, by 0.3% in April and 2.8% over the period, to another new record high. April's advance once again was broad-based, with only building permits (-0.07ppt) and stock prices (-0.01) contributing negatively. The biggest positive contributions came from the interest-rate spread (0.16), jobless claims (0.10), consumer expectations (0.08), and the average workweek (0.07); the remaining indicators—real nondefense capital goods orders, real consumer goods orders, the new orders diffusion index, and the leading credit index—added between 0.01-0.04ppt.

Coincident Indicators (*link*): The Coincident Indicators Index (CEI) in April advanced to yet another record high. The CEI hasn't posted a decline in 13 months, increasing 0.3% m/m and 2.3% over the time span. Once again, all four components contributed positively last month, with all but industrial production climbing to new record highs, though it did post the biggest positive contribution for the second straight month: 1) Industrial production advanced for the fourth time in five months by 1.0% in April and 2.1% over the period, to its highest level since March 2015. 2) Nonfarm payroll employment climbed for the 11th month by 0.1% m/m and 1.5% over the period. It hasn't posted a decline since July 2010. 3) Real personal income—excluding transfer payments—continues to rise after stalling in early 2016 at record highs; it's up 3.2% since declining 0.4% the first two months of 2016. 4) Real manufacturing & trade sales advanced 3.8% during the 11 months ending April.

Regional M-PMIs (*link*): Two Fed districts so far have reported on manufacturing activity for May—New York and Philadelphia—and averaged together show an acceleration in activity. The composite index climbed to 18.9 after slipping the previous two months to 13.6 in April from 31.0 in February—which was the highest reading since July 2004. A pickup in the Philadelphia (to 38.8 from 22.0) region more

than offset the first contraction in New York's (-1.0 from 5.2) since October. The new orders gauge slipped for the second month to 10.5 from 30.0 in March, which was the best reading since summer 2004. Over the two-month period, Philadelphia's gauge (25.4 from 38.6) slowed but remained at a high level, while New York's (-4.4 from 21.3) swung from expansion to contraction. Meanwhile, the employment measure was little changed around April's cyclical high, easing to 14.6, after improving the prior five months from -7.5 in November to 16.9 last month—which was the best hiring pace since April 2012. Manufacturers in both the Philadelphia (17.3 from 19.9) and New York (11.9 from 13.9) regions are adding to payrolls at a robust pace.

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