MORNING BRIEFING
May 31, 2017

A Memorable Earnings Season

See the collection of the individual charts linked below.

(1) Seasonal drop, but y/y growth. (2) Forward earnings at record highs. (3) Tax cuts wading through the swamp. (4) Winning streak: Profit margin remains at record high. (5) A traumatic legacy. (6) Resource utilization rate still below previous cyclical peaks. (7) NBx2 scenario: No Boom, No Bust. (8) Double-digit earnings growth for S&P 500 Financials, IT, and Materials. (9) Revenue growth rising along with other measures of economic activity. (10) Aggregate vs per-share growth.

Strategy: Revenue Growth Rebounding. Joe reports that Q1 revenues, earnings, and margins are now available for the S&P 500. Revenues per share dropped 2.7% q/q during Q1. Earnings per share, based on Thomson Reuters I/B/E/S (TR) data, fell 1.3% q/q. So in what sense was the Q1 reporting season "memorable," as stated in the title of today's commentary?

For starters, the S&P 500 rose to a new record high of 2415.82 on May 26 (*Fig. 1*). The S&P 400 and S&P 600 stock price indexes continued to mark time at their recent record highs. Industry analysts remained upbeat about earnings for this year and next year, as reflected by the record highs in the S&P 500/400/600 forward earnings (*Fig. 2*).

This all happened despite a growing realization that President Trump's economic agenda is likely to be slowed by Washington's swampy ways. Joe and I came to that epiphany on May 18 and pushed the corporate tax cut into 2018 from 2017. Without a tax cut, we estimate that S&P 500 earnings per share will be $130.00 this year and $136.75 next year. With the tax cut in 2018, our estimate for next year gets raised to $150.00. (See *YRI S&P 500 Earnings Forecast*.) Let's have a closer look at the results of the latest reporting season:

(1) *Good growth.* Of course, the apparent weakness in Q1's revenues and earnings on a q/q basis is mostly seasonal in nature. The first quarter of the year tends to be the weakest one of the year (*Fig. 3* and *Fig. 4*). On a y/y basis, revenues per share rose 6.9%, the fastest since Q4-2011 (*Fig. 5*). Earnings per share rose 14.5% y/y, the best growth since Q3-2011 (*Fig. 6*).

Joe and I argued that the S&P 500 revenues recession during 2015—when y/y growth rates were down each quarter—was mostly attributable to the plunge in the revenues of the energy sector. The revenue growth rates, which turned slightly positive during Q1-2016, have been increasing since then. It was last summer that we declared the end of the earnings recession. The y/y growth rate of earnings turned positive during Q3-2016 at 4.2%, rose to 5.9% during Q4-2016, and chalked up 14.5% at the start of this year.

(2) *High & stable margin.* The profit margin of the S&P 500, based on TR data, rebounded sharply from a record low of 2.4% during Q4-2008 back to its previous cyclical peak of 9.6% during Q3-2011 (*Fig. 7* and *Fig. 8*). There was lots of growling by the perma-bears that it would soon revert to its mean. Instead, it continued to rise to a new record high of 10.7% during Q3-2016. It has remained around there since then, registering 10.5% during Q1.

Joe and I argued that following the Trauma of 2008, company managements would do whatever they could to raise and maintain their profit margins by remaining conservative in their spending plans despite record profits. We aren't saying that the profit margin will never revert again. It will do so come the next recession. But that downturn may not come for a while because companies are being conservative.

In the past, the profit margin would often peak before recessions as companies went on hiring and capacity expansion sprees (*Fig. 9*). The resulting boom would create the borrowing and inflationary excesses that set the stage for the inevitable bust. This time, the economy isn't booming the way it often has at this late stage of an expansion. No boom, no boost … at least not in the foreseeable future.

There is some correlation between the profit margin (using GDP data, which have a much longer history than the S&P data) and the economy's resource utilization rate (RUR), which is the average of the capacity utilization rate and the employment rate (*Fig. 10*). RUR is near its 2014 cyclical high, but below all previous cyclical highs since 1967. No boom, no bust. We've written about this scenario over the past couple of years. We are christening it our "NBx2" scenario.

(3) *Sectors.* Joe analyzes the earnings of the S&P 500 sectors using both TR and S&P data (*Fig. 11*). Both are on an operating (pro forma) rather than reported (GAAP) basis. The TR composite is based on the estimates of industry analysts who tend to be more liberal than the S&P's internal estimates of one-time expenses and income.

Focusing on the TR earnings data, Joe reports the following y/y earnings growth rates for the S&P 500 sectors, from best to worst: Financials (28.4), Tech (21.1), Materials (20.6), Health Care (6.4), Consumer Staples (5.6), Consumer Discretionary (5.4), Industrials (1.6), Utilities (1.1), and Telecom (-5.0). Energy has come back from the dead impressively, recording earnings at a six-quarter high versus a loss a year ago. But the double-digit growth rates of Financials, Information Technology, and Materials are also impressive. Health Care's mid-single-digit growth rate is lackluster. Industrials' low-single-digit gain is disappointing, but should improve in coming quarters.

(4) *Correlations.* We aren't surprised by the solid rebound in S&P 500 revenues because its y/y growth rate tends to be nearly the same as the comparable growth rate for manufacturing and trade sales, even though this series is limited to goods and does not include services (*Fig. 12*). Aggregate (not per-share) revenues was up 5.2% y/y during Q1, while business sales rose 6.4% through March.

Revenues per share on a y/y basis tends to lag the US M-PMI (*Fig. 13*). The latter remains relatively high and consistent with revenue growth around 5%.

Not surprisingly, there is a decent correlation between the y/y growth rate in nominal GDP and aggregate S&P 500 revenues (*Fig. 14* and *Fig. 15*).

(5) *Aggregate vs per share.* By the way, on a y/y basis through Q1, S&P 500 revenues grew 5.2% in aggregate and 6.9% per share (*Fig. 16*). Operating earnings (using TR data) increased 12.7% in aggregate and 14.5% per share (*Fig. 17*).

CALENDARS

US. Wed: MBA Mortgage Applications, EIA Petroleum Status. **Thurs:** ADP Employment 170k, Jobless Claims 239k, Challenger Job-Cut Report, Productivity & Unit Labor Costs -0.5%/2.9%, Construction Spending 0.5%, Motor Vehicle Sales 16.9mu, ISM & Markit M-PMIs 54.6/52.5, Weekly Consumer Comfort Index, EIA Natural Gas & Petroleum Status Reports. (Bloomberg estimates)

Global. **Wed:** Canada Retail Sales Total and Ex Autos 0.2%/-0.3%, Australia CPI 2.2% y/y, Japan Small Business Confidence 49.4, Lowe. **Thurs:** Italy GDP 0.2%q/q/0.8%y/y, Eurozone, Germany, France, and Italy M-PMIs 57.0/59.4/54.0/56.1, UK M-PMI 56.5, China Caixin-Markit M-PMI 50.2, Japan M-PMI. (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—rebounded 2.3% during the two weeks ending May 20 to a new record high. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). Our BBB rebounded 3.4% over the two-week period, also reaching a new record high as jobless claims fell to 235,250 (4-wa)—the lowest since April 1973. The CRB raw industrial spot price index—another BBB component—is holding around recent highs. Meanwhile, the WCCI is fluctuating around recent highs, climbing 2.3% the past two weeks, reversing the prior week's 2.4% decline.

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose last week to record highs for LargeCap and MidCap, and SmallCap improved to 0.1% below its early May record. 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 was steady at 9.8% y/y, which compares to a 64-month high of 10.2% three weeks ago and a six-year low of -1.8% in October 2015; MidCap's was steady at a 32-month high of 12.6%, which compares to a six-year low of -1.3% in December 2015; and SmallCap's improved to 11.2% from a 15-week low of 11.0%, 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 11.4% and 11.9%, MidCap 11.4% and 13.3%, and SmallCap 8.6% and 19.6%.

S&P 500/400/600 Forward Valuation (*link*): Forward P/E ratios were slightly higher for all three indexes last week. Valuations have improved from their more-than-five-month lows in mid-April, 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 w/w to 17.5 from 17.3 and 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 edged up to 18.0 from 17.9, which compares to a 15-year high of 19.2 in late February and the record high of 20.6 in January 2002. MidCap's is up from a three-year low of 15.0 in January 2016. SmallCap's improved to 19.2 from 19.1, which compares to a 15-year high of 20.5 in early December, when Energy's earnings were depressed. That's up from a three-year low of 15.5 in February 2016 and remains close to SmallCap's record-high P/E 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 1.90 and MidCap's 1.25 are close to their recent record highs of 1.94 and 1.37, while SmallCap's 0.99 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 slightly to the upside last week, as expected following the positive earnings surprise hook for Q1. The Q2 consensus rose w/w for four of the 11 S&P 500 sectors, was steady for four, and fell for three. Real Estate's Q2 forecast rose 0.8% w/w, followed by gains for Tech (0.3%), Industrials (0.3), and Health Care (0.2). Sectors with the biggest w/w decline in their Q2 forecast: Materials (-2.2), Energy (-0.5), and Consumer Discretionary (-0.1). The S&P 500's Q2-2017 EPS forecast rose 2 cents w/w to $31.56, and is down just 1.6% from $32.04 at the end of Q1. That represents a forecasted pro forma earnings gain for Q2-2017 of 8.5% y/y, down from Q1's blended 15.4%, which is the strongest growth since Q3-2011 owing mostly to easier comps for Energy. The Q2-2017 forecast is down from 8.6% a week earlier and 11.9% at the end of Q4. Since the end of Q1, Q2 estimates are lower for nine sectors and higher for two. Real Estate's Q2 forecast has risen 2.4%, followed by a 0.5% gain for Industrials. Energy has dropped 7.6% for the worst decline, followed by Materials (-4.0), Telecom (-3.8), and Consumer Discretionary (-3.3). The S&P 500's Q2-2017 forecasted earnings gain of 8.5% 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 8.5%. That's because analysts expect Energy to report a large profit jump in Q2 relative to very low earnings a year ago. Still, that matches the 10/11 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 (761.5% in Q2 versus a return to a profit in Q1), Tech (10.8% vs. 20.6%), Financials (9.6, 19.9), S&P 500 (8.5, 15.4), Materials (5.0, 19.3), Consumer Staples (3.5, 3.6), Real Estate (3.4, 2.8), Health Care (2.4, 7.2), Telecom (1.6, -4.9), Industrials (1.6, 4.0), Consumer Discretionary (1.1, 6.1), and Utilities (-3.1, 2.7).

US ECONOMIC INDICATORS

Personal Income & Consumption (*link*): Real consumer spending in April expanded for the second month after contracting the first two months of the year. Real PCE rose 0.8% in the two months ending April after falling 0.4% the prior two months. Real goods consumption rebounded 1.0% over the two-month period, with both durable (1.4%) and nondurable (0.8) goods consumption recording robust gains over the period; real services consumption was flat in April after rebounding 0.6% in March. Real incomes are picking up. Over the three months through April, based on a three-month average, real personal income (3.0%, saar) grew at its fastest pace since last September as real wages & salaries (3.8) accelerated sharply, suggesting real PCE will pick up this quarter from Q1's anemic 0.6% (saar) pace. Our Earned Income Proxy, which tracks wages & salaries and consumer spending closely, supports this scenario, as it continues to set new record highs.

Consumer Confidence Index (*link*): Consumer confidence retreated for the second month in May, but retained most of the post-election surge. The Consumer Confidence Index slipped to 117.9 this month after soaring from 100.8 in October to 124.9 in March—which was the highest since December 2000. The recent setback was driven by a 9.7-point drop in the expectations component from 112.3 in March (the highest since September 2000) to 102.6 this month. The present situation component remained near March's cyclical high, ticking up to 140.7 after falling from 143.9 to 140.3 in April. Consumers viewed both the current and short-term outlook on the labor market favorably, though the latter's deteriorated a bit. This month, the percentage of respondents saying jobs are plentiful slipped only slightly for the second month, to 29.9 from 31.8 in March—which was the highest since August 2001, while those saying jobs are hard to get dropped to 18.2%, the lowest since February 2007. The consumers' six-month job outlook weakend a bit, with those expecting more jobs dropping for the second month from 23.8% to 18.6% over the period; those expecting fewer jobs, however, fell to a new cyclical low of 12.0%. May's spread narrowed for the second month to 6.6ppts from 11.1pts in March, which was the most favorable since January 1984!

GLOBAL ECONOMIC INDICATORS

Eurozone Economic Sentiment Indicators (*link*): The Economic Sentiment Index (ESI) for both the Eurozone (-0.5 points to 109.2) and the EU (-1.0 points to 109.7) softened in May following big gains in April to their highest levels since August and September of 2007, respectively. This month, two of the five largest Eurozone economies posted gains, with France (+1.5 to 107.7) posting its second 1.0-plus-point gain to its highest reading since June 2011; Spain (+0.5 to 108.4) was also in the plus column, just shy of February's 14-month high. ESIs for the Netherlands (-2.1 to 107.6) and Germany (-1.5 to 109.5) fell markedly after climbing to new cyclical highs in April; Italy's (-0.9 to 106.1) held near recent highs. At the sector level, consumer (+0.3 to -3.3), construction (+0.3 to -5.7), and industry confidence (+0.2 to 2.8) all climbed to new cyclical highs, while services confidence (-1.2 to 13.0) slipped from April's cyclical high; retail trade confidence (-1.1 to 2.0) remained in a volatile flat trend.

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