Yardeni Research, Inc.

MORNING BRIEFING
June 1, 2017

United Tech, Divided Transports

See the collection of the individual charts linked below.

(1) FAANG and headless headlines. (2) 10 Bennies for 1 Amazon. (3) Amazon is in the wrong aisle. (4) Active managers overweighting FAANG. (5) Tech accounts for a bit more than a fifth of S&P 500 earnings and market-cap shares. (6) Dow Theory remains bullish. (7) Rails are back on fast track. (8) Airlines have lots of passengers they can drag off planes. (9) Trucking industry's freight tonnage stalled at record high. (10) Truck prices falling.

Technology Sector: FAANG Fans. Large, round numbers make for eye-catching headlines. They may not be as infamous as the *New York Post's* "Headless Body in Topless Bar," but as the bull market climbs ever higher, index milestones garner their fair share of attention. The fanfare continued in May as the S&P 500 broke through 2,400 for the first time.

The latest leg up in the market owes much to the FAANG stocks, including Amazon, which landed in the headlines because its stock price briefly crossed past $1,000 on Tuesday. That 10-Benjamins threshold brought into sharp focus the stock's impressive 50,920% return since its IPO at a split-adjusted $1.96 on May 15, 1997. Amazon is the stock every investor would like to say they were smart enough to buy and hold through good times and bad.

Amazon's ascendancy also reflects the enthusiasm that has returned to the S&P 500 Tech sector. Yes, we know that Amazon is officially in the Consumer Discretionary sector. However, it's easily argued that the stock—with its focus on the Internet, software, and cloud services—looks, swims, and quacks more like a Tech stock.

The S&P 500 Tech sector index has risen 20.0% ytd through Tuesday's close, far outpacing its fellow S&P 500 sectors: Consumer Discretionary (11.4), Health Care (9.6), Utilities (9.6), Consumer Staples (9.1), S&P 500 (7.8), Industrials (6.9), Materials (6.1), Real Estate (3.3), Financials (0.5), Telecom Services (-10.4), and Energy (-13.2) (*Fig. 1*).

The tech trade certainly isn't undiscovered. "Funds tracked by Bank of America Corp. own the highest percentage of technology stocks on record compared to their benchmark. … And it's giving active managers a boost they haven't seen in more than two years," a 5/30 Bloomberg article reported.

The article went on to say that 71% of active fund managers are now overweight the FAANG stocks. The returns of Facebook (up 27.6% y/y through Tuesday's close), Amazon (39.9), Apple (53.1), Netflix (58.0), and Google (33.2) account for more than a quarter of the S&P 500's 15.0% y/y return through Tuesday's close.

But even the strong FAANG stock returns understate the enthusiasm that investors have had for the true go-go stocks in the Tech sector. Leading the pack are semiconductor stocks like Nvidia, up 215.6% over the past year, Micron Technology (149.4%), and Advanced Micro Devices (141.7), to name a few of the industry's most impressive returns.

The stock of Autodesk, which develops software to create things, gained 90.7% over the past year. And straggling behind are the gaming software companies Electronic Arts and Activision Blizzard, which have posted 49.1% and 48.9% one-year gains.

The S&P 500 Tech sector (which, again, does not include amazing Amazon) sports a forward P/E of 18.5, slightly above the S&P 500's forward P/E of 17.7 (*Fig. 2*). However, both the Tech sector and the S&P 500 are expected to have earnings growth of 11.2% on average over the next 12 months (*Fig. 3*). Nervous bulls might be glad to learn that the S&P 500 Tech sector's share of the S&P 500's market capitalization, at 23.1%, is only slightly above the sector's share of the S&P 500's earnings, 22.0%. At the peak of the 2000 bubble, the Tech sector's market-cap share was 32.9%, and its contribution to S&P 500 earnings was only 15.4% (*Fig. 4*).

Transportation Industry: Taking Different Roads. The Dow Jones Industrial Average also found itself in the headlines last month as it crossed past 21,000 once again. The index reached its highest price of 21,115 on March 1, and it has edged down 0.4% since then. Dow Theory adherents undoubtedly were happy to see that on the same day, the Dow Transports hit a new high of 9,593, confirming the move in the DJIA. The Transports have also fallen back a bit—by 4.5%—since then (*Fig. 5*).

The new high in the Transports is impressive given the bifurcated performance of the industries in the index. While the airlines and rails have enjoyed stellar performances over the past year, the truckers and marine companies have dropped or simply underperformed, holding the index back. I asked Jackie to have a look at why the Transport industries are producing such different returns:

(1) *Rails on fast track.* In 2010, Warren Buffett made a $26 billion bet on the rails by buying Burlington Northern Santa Fe. So far, so good. The S&P 500 Railroads industry is one of the best-performing industries in the S&P 500, up 18.1% ytd and 48.4% over the past year (*Fig. 6*).

The industry has recovered nicely from sharp declines in coal shipments that ran from 2009 through last year (*Fig. 7*). With coal volumes bottoming and shipments of chemicals, plastics, and petroleum on the rise, overall rail shipments should start growing again. Excluding coal, railcar loadings have plateaued (*Fig. 8*).

Shares of CSX have been the best performer in the railroad industry, up 50.9% ytd and 108.4% y/y, as Hunter Harrison was brought in by an activist investor to be CEO. Harrison is known as a turnaround pro and has already instituted a plan to improve the railroad's efficiency by idling 550 locomotives and 25,000 railcars, the 3/6 *WSJ* reported.

The S&P 500 Railroad industry is expected to post strong results this year. Revenue is expected to grow 5.6% in 2017, compared to the 7.1% decline last year. Likewise, this year's earnings are expected to grow 13.6%, following last year's 15.9% gain (*Fig. 9*). Analysts' earnings expectations for the rails have been improving all year long (*Fig.10*). However, the industry's valuation bears watching: While its forward P/E has come down from a record high of 20.2 during January to 18.0, the multiple remains higher than it has been going back to the mid-1990s (*Fig. 11*).

(2) *Airlines flying high.* Airlines should be wary of the turbulence that analysts are expecting this year and next. While revenues are expected to climb 4.7% over the next 12 months, earnings are expected to grow only 1.9% (*Fig. 12*).

But despite that tepid forecast, S&P 500 Airlines' shares have gained 6.5% ytd, perhaps because earnings growth is expected to pick up next year to 15.5% (*Fig. 13*). Recently, American Airlines and

United indicated that the supply of seats in the industry remains tight relative to the number of customers looking to book tickets. United Airlines, which recently found itself in the headlines after a customer was dragged off a plane, said it expects passenger revenue for each seat flown a mile to rise by 1%-3% y/y. Likewise, American Airlines predicted passenger revenue per seat would increase 3.5%-5.5%.

"The new forecasts signal increased confidence by American that it will post unit-revenue gains for a third straight quarter, after a 2015 discount war and excess capacity had forced ticket prices down for about two years. Higher average fares and lower estimated fuel prices led to the improved outlook, American said," according to a 5/9 Bloomberg article.

(3) *Truckers stopped.* The trucking industry has hit a pothole. The S&P 500 Trucking index has risen only 1.4% y/y, and it has fallen 11.3% ytd (*Fig. 14*). Investors may be somewhat concerned that trucking volumes have plateaued at a high level over the past year after soaring from 2009 through 2015 (*Fig. 15*). Additionally, the declining price of used trucks is hurting the value of trucking companies' assets, all while the long-running lack of drivers is forcing companies to increase wages.

A few years ago, when volumes were growing strongly, trucking companies went on a truck-buying spree. Large, long-haul trucking companies typically use a truck for three to five years and then trade it in before the warranty expires. Now, as they're ready to trade in the trucks, overcapacity is causing the price of used trucks to decline, putting pressure on the overall value of the companies' truck portfolios (*Fig. 16*).

"Over the past two years, the average retail price for a used Class 8 sleeper, the heavy-duty tractor used for long-haul routes, has plunged about 22% to about $49,000 in March, according to J.D. Power Valuation Services. That translates into a decrease of some $140 million across a fleet of 10,000 trucks," the 5/12 *WSJ* reported. The number of new trucks sold never rose as high as it did in previous cycles, and truck sales may have bottomed out at a higher level as well.

Perhaps smelling opportunity, Swift Transportation and Knight Transportation announced in April plans to merge. At the time, both companies had similar market caps, however, Swift is the fifth largest trucking company by revenue, and Knight is the 22nd largest, the 4/10 *WSJ* reported. Knight's CEO will lead the merged company, as Knight is considered a better operator with better margins.

The trucking industry has also been increasing wages in an effort to ease a driver shortage. But it's tough to see why someone would consider making truck driving a career if autonomous trucks are in the industry's future. Tesla has said it plans to unveil in September an electric truck, which analysts believe will be at least partially autonomous, Bloomberg reported on 4/13. And they're not alone. Starsky Robotics is a startup working on the problem, and Uber bought Otto last summer to get a jumpstart in the industry, according to a 3/30 *FT* article.

The S&P 500 Trucking industry is expected to grow revenues by 6.4% over the next 12 months, but earnings expectations have come down sharply over the past year, leaving growth estimates for the next 12 months at 3.0% (*Fig. 17* and *Fig. 18*). Despite the below-market earnings growth, the industry's forward P/E, at 17.7, remains near the highs of this cycle, and not far from the S&P 500's multiple (*Fig. 19*).

CALENDARS

US. 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. **Fri:** Total & Private Nonfarm Payroll Employment 185k/172k, Unemployment Rate 4.4%, Average Hourly Earnings 0.2%m/m/2.6%y/y, Average Workweek 34.4hrs, Advance Merchandise Trade Balance -$46.1b, Baker-Hughes Rig Count, Harker. (Bloomberg estimates)

Global. 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. **Fri:** Japan Consumer Confidence 43.5. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): The Investors Intelligence Bull/Bear Ratio (BBR) sank for the second week this week to 2.60—the lowest since the last week of November. This week's reading is only the fourth below 3.00 this year. Bullish sentiment sank for the third week from 58.7% to 50.0%, nearing the late-March reading of 49.5%, which was the fewest bulls since the November election. Bearish sentiment climbed to a high for this year of 19.2%, breaking out of the narrow 16.5%-18.3% range held since the end of last year. Meanwhile, the correction count climbed for the fourth week from a nine-week low of 23.6% to 30.8% over the period—near its high for the year of 32.4% at the end of March. The AAII Bull Ratio rose to 52.3% last week after falling from 56.0% to 41.0% the prior two weeks. Bullish sentiment rose from 23.9% to 32.9% last week, while bearish sentiment fell from 34.3% to 30.0%.

S&P 500 Earnings, Revenues & Valuation (*link*): S&P 500 consensus forward revenues rose for the first time in three weeks to a record high, and forward earnings was at a record high for an eighth straight week. The forward profit margin forecast was also at a record high, but steady w/w at 10.9%. The profit margin's record high is its first since September 2015 and up from a 24-month low of 10.4% in March 2016. Forward revenue growth for the S&P 500 edged up w/w to 5.4% from 5.3%, but that's down from 5.8% in late January, which was the highest since May 2012 and compares to a cyclical low of 2.7% in February 2016. Forward earnings growth improved to 11.2% from 11.1%, which is down from 11.7% in January; that was the highest since October 2011 and compares to a cyclical low of 4.8% in February 2016. S&P 500 forward revenues and forward earnings growth are enjoying a tailwind now due to easy y/y comparisons for Energy and improving prospects for Financials, but currency translation is likely to be a slight drag. However, Energy's contribution to forward growth peaked at the start of 2017. Looking at last week's results for the S&P 500 ex-Energy, the forward growth rates for revenues (4.5%) and earnings (8.7) are lower. The ex-Energy forward profit margin was steady at 11.5%, matching its record high of 11.5% in August 2007. Valuation rose w/w to a four-week high of 17.7 from 17.3, which compares to a 13-year high of 18.0 in early March and a 15-month low of 14.9 in January 2016. Ex-Energy valuation rose to 17.3 from 17.0, which is down from a 13-year high of 17.6 in early March.

S&P 500 Sectors Earnings, Revenues & Valuation (*link*): Consensus forward revenue forecasts rose last week for 9/11 sectors, and forward earnings rose for 6/11. Consumer Discretionary and Telecom had both measures decline w/w, while these six had both measures rise: Consumer Staples, Energy, Financials, Health Care, Industrials, Real Estate, 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 stalling recently near 15-month highs. Forward P/E ratios rose w/w for all 11 sectors, and the forward P/S ratio was up for all but Energy and Materials. Financials' P/E is up from 12.0 before the election to 13.4, but that's down from a post-election high of 14.6 in early March. Health Care's P/E of 15.7 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 1.32 compares to a record high of 1.56 in May 2016, and its P/E of 25.8 is down from a record high of 57.5 then. Higher y/y margins occurred for only 7/11 sectors in 2016, and margins 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 19.8% in 2017 from 19.2% in 2016), Real Estate (16.9, 25.2), Financials (15.7, 14.4), Telecom (11.3, 11.2), Utilities (10.9, 11.4), S&P 500 (10.6, 10.1), Health Care (10.4, 10.3), Materials (10.0, 9.4), Industrials (9.1, 8.8), Consumer Discretionary (7.4, 7.2), Consumer Staples (6.7, 6.5), and Energy (4.4, 1.1).

US ECONOMIC INDICATORS

Regional M-PMIs (*link*): Five Fed districts now have reported on manufacturing activity for May—New York, Philadelphia, Richmond, Kansas City, and Dallas. We average the composite, orders, and employment measures as data become available. The composite index fell for the third month to 12.8 last month from 23.5 in February, which was the highest reading since July 2004. A pickup in the Philadelphia (to 38.8 from 22.0) region, and a slight uptick in the Dallas (17.2 from 16.8) and Kansas City (8 from 7) regions, was more than offset by a sharp slowing in Richmond's (1 from 20) to a near standstill and the first contraction in New York's (-1.0 from 5.2) since October. The new orders gauge slipped for the second month to 9.6 from 25.5 in March, which was a high for the series going back to 2004. Over the two-month period, only Dallas (18.1 from 9.5) orders accelerated, while Philadelphia's (25.4 from 38.6) and Kansas City's (9 from 32) slowed—with the former remaining at a very high level; Richmond's (0 from 26) fell to zero and New York's (-4.4 from 21.3) swung from expansion to contraction. Meanwhile, the employment measure slowed for the second month to 10.9, though held near March's cyclical high of 13.5, which was the best hiring pace since May 2011. Manufacturers in the Philadelphia (17.3 from 19.9), New York (11.9 from 13.9), Kansas City (11 from 9), and Dallas (8.3 from 8.5) regions added to payrolls at a robust pace, while employment in the Richmond area slowed significantly, with its measure falling from a cyclical high of 20 in March to 6 this month.

Pending Home Sales (*link*): "Prospective buyers are feeling the double whammy this spring of inventory that's down 9.0 percent from a year ago and price appreciation that's much faster than any rise they've likely seen in their incomes," according to NAR's chief economist. The Pending Home Sales Index—measuring sales contracts for existing-home purchases—slumped for the second month in April to 109.8, putting the index 3.3% below a year ago—the first y/y decline since last December and the largest since June 2014. Regionally, only the West showed an increase in sales in April, though all regions were below year-ago levels: Midwest (-6.1% y/y), West (-4.2), South (-2.3), and the Northeast (-0.6). Realtors are indicating that foot traffic is higher than a year ago, though it's not translating to more sales.

GLOBAL ECONOMIC INDICATORS

Eurozone CPI Flash Estimate (*link*): May's CPI rate is expected to be 1.4% y/y, falling back below the ECB's goal of just under 2.0%; April's 1.9% rate was in line with the ECB goal. Looking at the main components, energy (to 4.6% from 7.6% y/y) is expected to have the highest annual rate, though easing to a five-month low; the services rate (1.3 from 1.8) is also expected to slow. Meanwhile, the rates for food, alcohol, and tobacco (1.5) and non-energy industrial goods (0.3) are expected to match their April rates. The core rate—which excludes energy, food, alcohol, and tobacco—is expected to slow to 0.9% from 1.2% in April, which was the highest in almost four years.

Contact us by email or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor & Webmaster, 570-775-6823