MORNING BRIEFING
June 21, 2017

Earnings Boom

See the collection of the individual charts linked below.

(1) Among the weakest economic expansions, weighed down by both consumer and business spending. (2) The Trauma of 2008 was traumatizing. (3) No boom, no bust: Only 25 months to go to make this the longest expansion. (4) Profits performance remarkably good considering weakness in nominal GDP. (5) Profit margins still aren't reverting. (6) There is a boom in our Boom-Bust Barometer, which remains bullish for earnings. (7) Forward earnings are flying high in numerous S&P 500 industries.

Earnings I: Diverging from GDP. The current economic expansion has been among the weakest on record. More specifically, of the seven cyclical upturns in real GDP since 1961, it has been the second weakest (*Fig. 1*). The big drag has been consumer spending (*Fig. 2*). Interestingly, real consumer outlays on goods has been the third weakest, while real consumer expenditures on services has been the weakest among these seven expansions (*Fig. 3* and *Fig. 4*). Weighing on services this time are spending on health care services, housing & utilities, and financial services & insurance.

Capital-spending growth also has been subpar during the current expansion, led by weakness in technology equipment, structures, and intellectual property (which includes software). On the other hand, spending on transportation equipment has been the strongest among all the expansions since 1961. Government spending on goods and services in real GDP has been the weakest. (See our *GDP Expansion Cycles*.)

During most of the current bull market, Debbie and I have argued that subpar economic growth should be bullish for stocks. In our opinion, the Trauma of 2008 was a major contributor to the subsequent slow pace of growth. Both consumers and businesses were traumatized by the event, and were likely to proceed with much more caution than in the past. Such conservative behavior reduced the inflationary potential of the current expansion. It also lowered the odds of speculative excesses. We've dubbed this our "NBx2" scenario, i.e., No Boom, No Bust. This implies that the expansion could be among the longest. It already is the third longest since World War II. It only has to keep going another 25 months through July 2019 to surpass the longest one from March 1991 to March 2001.

Yet despite the subpar pace of nominal GDP, corporate profits have performed remarkably well. The rise in the GDP price deflator during the current expansion is the weakest since 1961 (*Fig. 5*). The expansion in nominal GDP is also the weakest over this same period (*Fig. 6*). Now consider the remarkable performance of various measures of corporate profits:

(1) *Trends.* From 1960 through 2008, nominal GDP and corporate profits as measured in the National Income & Product Accounts (NIPA) rose together along a trendline of 7% (*Fig. 7*). They've diverged since then, with profits continuing to grow along the 7% trendline while nominal GDP growth has fallen below it. Other measures of profits such as S&P 500 reported, operating, and forward earnings are still tracking the 7% trendline. The first two are available quarterly and arguably aren't tracking quite as well as forward earnings, which is available monthly and weekly (*Fig. 8*).

(2) *Cycles.* Comparing the profits expansions since 1961, using the profit-cycle troughs as the starting

points, we see that the current one is the third best so far of the seven (*Fig. 9*). Granted, that's not a fair comparison, because it says more about the depth of the profits recession during 2008 than the strength of the profits expansion.

(3) *Profit margins.* Nevertheless, there's no denying that the current profits upturn has been boosted not only by the cyclical rebound in profit margins to record highs, but also their ability to maintain those highs for so long. In the past, the forces of reversion-to-the-mean would have started to erode margins by now as boom-time conditions fed on themselves by stimulating more (margin-reverting) business spending than we are seeing this go-round (*Fig. 10* and *Fig. 11*).

(4) *Boom-Bust Barometer.* While there is neither a boom nor a bust in the overall economy, our Boom-Bust Barometer (BBB) continues to boom (*Fig. 12*). It's gone vertical since early 2016. We calculate it simply as the weekly average of the CRB raw industrials spot price index divided by the four-week average of initial unemployment claims. The numerator is a gauge of global economic activity, while the denominator is a measure of labor market tightness in the US.

Previously, we have shown that our BBB is highly correlated with S&P 500 forward earnings, i.e., the time-weighted average of analysts' consensus earnings expectations for the current year and the coming year (*Fig. 13*). They are still highly correlated and rising together in record-high territory.

Earnings II: Where Eagles Dare. Jackie, Joe, and I regularly monitor our *S&P 500 Sectors & Industries Forward Earnings (Indexed)*. This chart publication compares the performances of the forward earnings of the 10 S&P sectors and numerous industries since the start of the current bull market. We find it to be a handy way to pick out where industry analysts are seeing outperformance and underperformance in their estimates of earnings. Here are some of our latest findings:

(1) *Sectors.* Excluding autos (because the industry lost so much money during the Great Recession), S&P 500 forward earnings is up 95.3% since the week of March 5, 2009 (*Fig. 14*). Leading the way higher, especially since early 2016, is the IT sector, which is now up 209.6%. Coming from behind since September 22, 2016 is the Financials sector, which now ties the Consumer Discretionary (ex-Autos) sector for second place, with a gain of 157.7%. It was boosted last year when REITs were removed to create an 11th sector for the S&P 500. The laggard and only loser is Energy, with a decline of 33.9%.

(2) *Consumer Discretionary.* Among the big winners in this sector that continue to show plenty of upside forward earnings momentum are Hotels, Resorts, & Cruise Lines; Home Improvement Retail; Movies & Entertainment; and Restaurants. The clunkers are Apparel, Accessories & Luxury Goods; Department Stores; and Specialty Stores.

(3) *Consumer Staples.* Tobacco has been on fire since early 2015. Drug Retail has been making a comeback this year after slipping last year from record highs. Packaged Foods & Meats has been making new highs at a leisurely pace since last summer. Soda has lost its fizz.

(4) *Financials.* Leading the sector's rebound since early last year are Diversified Banks, Investment Banking & Brokerage, and Asset Managers. They all are at record highs.

(5) *Health Care.* This sector's standout winner since the start of the bull market is the Managed Health Care industry (*Fig. 15*). It has gone nearly parabolic since the start of 2014. Health Care Equipment has resumed its climb to new record highs this year, while Pharmaceuticals has stalled since last year. Biotech seems to be recovering from its freefall earlier this year.

(6) *Industrials.* The standouts in this sector are Industrial Conglomerates, Industrial Machinery, and Aerospace & Defense. All three are on uptrends and making new highs. Rebounding from weakness over the past couple of years are Railroads and Construction Machinery & Heavy Trucks.

(7) *Information Technology.* Leading the way higher in this sector have been the Semiconductor Equipment and Semiconductor industries (*Fig. 16*). That's been especially so since early 2016. Making an impressive comeback after a brief fall in late 2015 is Technology Hardware, Storage & Peripherals.

(8) *Materials*. In this sector, among the hot industries have been, and continue to be, Diversified Chemicals and Specialty Chemicals. Steel has been making a comeback of sorts over the past year. Fertilizer & Agriculture Chemicals remains in the dumps.

CALENDARS

US. Wed: Existing Home Sales 5.55mu, MBA Mortgage Applications, EIA Petroleum Status. **Thurs:** Leading Indicators 0.3%, Jobless Claims 240k, Kansas City Manufacturing Index, FHFA House Price Index 0.5%, Weekly Consumer Comfort Index, EIA Natural Gas Report, Powell. (Bloomberg estimates)

Global. Wed: Japan Machine Tool Orders, Kuroda. **Thurs:** Eurozone Consumer Confidence -3, Canada Retail Sales Headline and Ex Autos 0.3%/0.7%, ECB Publishes Economic Bulletin. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Sectors Net Earnings Revisions (*link*): The S&P 500's NERI was positive for a second straight month in June for the first time in seven months as it improved to a six-year high of 6.2% from 5.3% in May. NERI was positive for 8/11 sectors and improved m/m for eight (compared to seven positive and 10 improving in May). That matches the highest number of sectors with positive NERI since July 2014, and the most to improve m/m since May 2016. Industrials topped all sectors again in June, with its highest reading since July 2010, and Consumer Staples was positive for the first time in 10 months. Tech has the longest positive NERI streak of 11 months, followed by Financials (9) and Industrials (4). Telecom is the worst, with 14 straight months of negative NERIs, followed by Consumer Discretionary (12) and Energy (3). Here are the sectors' June NERIs compared with their May readings, ranked in descending order: Industrials (16.2% in June, up from 14.9% in May), Tech (12.7, 10.7), Financials (12.4, 14.1), Health Care (8.6, 6.4), Real Estate (8.1, 4.1), Materials (3.8, 1.9), Utilities (1.5, 2.4), Consumer Staples (0.8, -4.0), Consumer Discretionary (-0.2, -1.5), Energy (-6.7, -2.7), and Telecom (-32.1, -34.7).

S&P 500 Earnings, Revenues & Valuation (*link*): S&P 500 consensus forward revenues edged down less than 0.1% w/w to 0.2% below its early June record high, but forward earnings was at a record high for an 11th straight week. The forward profit margin forecast edged up slightly w/w to a record high of 11.0%. 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 was steady w/w to 5.3%, and is 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 was steady at a 20-week high of 11.3%, 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 (4.6%) and earnings (9.1) are lower, but improving. The ex-Energy forward profit margin was steady w/w at a record high of 11.6%, which is its first since August 2007. Valuation edged up w/w to 17.8 from 17.7, 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 was steady at a 13-week high of 17.4, but 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 2/11 sectors, and forward earnings rose for 4/11 sectors. Materials was the only sector that had both measures rise w/w. 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 has stalled recently below its 15-month high in March, and forward earnings is stalled at early June's 21-month high. The forward P/S and P/E ratios rose w/w for 7/11 sectors (all but Consumer Discretionary, Consumer Staples, Tech, and Utilities). Financials' P/E is up from 12.0 before the election to 13.8, and is approaching the post-election high of 14.6 in early March. Health Care is improving too; its P/E of 16.1 and P/S of 1.69 are back up to March's 19-month highs of 16.1 and 1.70, respectively, but 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 1.30 compares to a record high of 1.56 in May 2016, and its P/E of 24.9 is down from a record high of 57.5 then. Higher y/y margins occurred for only 7/11 sectors in 2016, but 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 (17.1, 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 (9.9, 9.4), Industrials (9.2, 8.9), Consumer Discretionary (7.3, 7.2), Consumer Staples (6.7, 6.5), and Energy (4.4, 1.1).

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