MORNING BRIEFING
July 26, 2017

Earnings-Led Melt-Up?

See the collection of the individual charts linked below.

(1) Earnings trump worries, including Trump. (2) Nothing to fear but nothing to fear. (3) Stock prices rising along with earnings. (4) Consumer confidence survey confirms that life is good, and the labor market has plenty of job openings. (5) Germany having Oktoberfest in July. (6) Frictional unemployment in the US. (7) Excluding retiring seniors and studying juniors, there isn't much slack left in US labor market.

Strategy: Climbing a Wall of Earnings. Technicians and contrarians, especially contrarian technicians, are most bullish when everyone seems to be most bearish. They observe that some of the best bull markets have "climbed a wall of worry." The current bull market has certainly done so. Joe and I have counted 56 panic attacks since the start of this bull market in our *S&P 500 Panic Attacks Since 2009*.

Most recently, there was a one-day "Trump Impeachment Scare" on May 17 (*Fig. 1*). We count seven scares last year, including the "Endgame Panic" at the beginning of 2016, "Brexit" during the summer, and "FBI Flags HRC" last fall (*Fig. 2*). Since the start of the bull market, the panic attacks have been followed by relief rallies to new cyclical highs, then to new record highs since March 28, 2013 (*Fig. 3*). So here we are at yet another set of new record highs for the S&P 500/400/600 (*Fig. 4*). However, this year's ascent has occurred without any meaningful panic attacks. There's been no wall of worry. There's been nothing to fear but nothing to fear, as we observed in Monday's commentary titled "Summertime Lullaby."

Helping to allay fears have been the steady increases in the forward earnings of the S&P 500/400/600 to new record highs over the past year (*Fig. 5*). These uptrends have been supported by rising forward revenues for all three S&P composites (*Fig. 6*). Most encouraging is that stock prices have been rising along with forward earnings, so that the forward P/Es of the S&P 500/400/600 have actually edged down slightly so far this year (*Fig. 7*).

That's a very healthy development. Valuation multiples remain highly elevated, of course. But it isn't a melt-up if stocks are rising along with earnings rather than on higher valuation multiples.

Confidence I: US Consumers Upbeat. Another healthy development is that the current conditions component of our Consumer Optimism Index (COI) rose to a new cyclical high during July (*Fig. 8*). It is at the highest level since May 2001. Debbie and I calculate the COI as the average of the Consumer Sentiment Index (CSI) and the Consumer Confidence Index (CCI). The current conditions component of the latter tends to fluctuate with more amplitude than the former. It also tends to be a more sensitive indicator of labor market conditions. In the CCI survey, we put a lot of weight on the "jobs plentiful" series. Here is what it shows:

(1) *Bountiful*. The percentage of respondents agreeing that jobs are plentiful rose to 34.1% during July, the best reading since July 2001 (*Fig. 9*). The percentage saying jobs are hard to get fell to 18.0%, the lowest since February 2007. This series is highly correlated with the unemployment rate and suggests it could continue to fall (*Fig. 10*).

(2) *Help wanted.* The jobs plentiful series is highly correlated with the percent of small business owners with job openings, a series compiled by the National Federation of Independent Business (*Fig. 11*). The latter, on a three-month-average basis, rose to 32.3% during June, the highest since January 2001.

(3) *Wage paradox*. There are fewer and fewer labor market indicators suggesting that there is still slack in the labor market. The one that really stands out is wage inflation. It remains remarkably subdued given its past tight correlation with the jobs plentiful series (*Fig. 12*). During the past three business cycles, wage inflation rose to about 4.0% when the jobs plentiful reading was as high as it is now.

Confidence II: Off the Charts in Germany. Meanwhile, over in Germany, they've started Oktoberfest early. July's IFO Business Confidence Index soared to another fresh record high in July, led by its current conditions component (*Fig. 13* and *Fig. 14*). Could it be that the huge influx of immigrants is boosting economic growth over there? It always has when it happened in other countries in the past.

US Labor Market: Shortage of Slackers. In our spare time, Debbie and I have been slicing and dicing the US labor market data to determine whether the remarkably subdued pace of wage inflation is attributable to the availability of more slack than suggested by the unemployment rate, job openings, and consumer surveys.

As we've noted before, there are currently as many job openings as there are unemployed workers. Both are around 6 million. In our opinion, that confirms that the economy is at full employment, with only "frictional" unemployment caused by geographic and skills mismatches. But what about the low labor force participation rate? Could it be that there are still lots of working-age people who are NILFs (not in the labor force) because they had dropped out but are starting to come back? We don't think so. Many of the NILFs are retired Baby Boomers. In addition, more young adults are going from high school to college rather than straight to work. Consider the following:

(1) *Participation rate.* If the labor force participation rate of the civilian working-age population were still 65%, as it was when the unemployment rate peaked at 10.0% during October 2009, then the unemployment rate today would be 7.6% (*Fig. 15*). Instead, the jobless rate is only 4.4% because the participation rate has dropped to 62.8%.

Now, excluding people who are 65 years old or older from the numerator and denominator of the participation rate shows that the participation rate was 73.3% during June (*Fig. 16*). Removing 16-24 year olds as well results in a 77.2% participation rate.

(2) *Employment/population ratio.* Doing a similar analysis of the employment/population ratio shows it at 60.1% during June (*Fig. 17*). Excluding seniors, it was 70.1%; excluding seniors and juniors brings it up to 74.5%. It's certainly hard to see any slack in the unemployment rate for 25-54 year olds, which fell to only 3.8% during June (*Fig. 18*).

CALENDARS

US. Wed: New Home Sales 612k, MBA Mortgage Applications, EIA Petroleum Status, FOMC Meeting Announcement 1.125%. **Thurs:** Durable Goods Total, Ex Transportation, and Core Capital Goods 3.2%/0.4%/0.3%, Jobless Claims 240k, Advance Merchandise Trade -$65.0b, Kansas City Manufacturing Index, Chicago Fed National Activity Index 0.10, Weekly Consumer Comfort Index. (Bloomberg estimates)

Global. Wed: UK GDP 0.3%q/q/1.7%y/y, Australia CPI 2.2% y/y. **Thurs:** Germany Retail Sales

0.2%m/m/2.7%y/y, Germany Gfk Consumer Confidence 10.6, UK Gfk Consumer Confidence -11, Japan CPI Total, Core, and Core-Core 0.4%/0.4%/-0.1% y/y, Japan Jobless Rate 3.0%, Japan Retail Trade 0.5%m/m/2.3%y/y, BOJ Summary of Opinions at July 19-20 Meeting. (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—rose 0.8% during the week of July 15 after falling six of the prior seven weeks by 3.6%; it's within 2.9% of its record high recorded eight weeks ago. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). Our BBB climbed 1.1% after contracting six of the previous seven weeks by a total of 4.5%; it's 3.4% below its record high posted during the week of May 20. Jobless claims fell to 243,750 (4-wa) after rising from 235,500—which was the lowest since April 1973—to 246,000 the prior seven weeks. CRB raw industrial spot price index—another BBB component—drifted lower. Meanwhile, the WCCI rose 1.3% after falling five of the previous six weeks by 8.2%.

S&P 500 Sectors Net Earnings Revisions (*link*): The S&P 500's NERI was positive for a third straight month in July, its longest positive streak since it rose for five months through September 2014. NERI dropped to a still-strong 5.9% in July from a six-year high of 6.2% in June. NERI was positive for 8/11 sectors and improved m/m for seven (compared to eight positive and eight improving in June). That matches the highest number of sectors with positive NERI since July 2014, but is the lowest to improve m/m in four months. Industrials topped all sectors for a third straight month in July, with its highest reading in the 85 months since June 2010. Consumer Discretionary was positive for the first time in 13 months. Tech has the longest positive NERI streak of 12 months, the best since August 2011 when a 28-month streak ended. Financials has the next best positive streak at 10 months, followed by Industrials (5). Telecom is the worst recently, with 15 straight months of negative NERIs, followed by Energy (4). Here are the sectors' July NERIs compared with their June readings, ranked in descending order: Industrials (18.8% in July, up from 16.2% in June), Tech (13.2, 12.7), Health Care (10.4 [13-month high], 8.6), Financials (10.1, 12.4), Real Estate (9.4 [36-month high], 8.1), Materials (1.3, 3.8), Utilities (3.7 [32-month high], 1.5), Consumer Staples (-0.2, 0.8), Consumer Discretionary (0.4 [13-month high], -0.2), Energy (-15.5 [15-month low], -6.7), and Telecom (-29.6, -32.1).

S&P 500 Earnings, Revenues & Valuation (*link*): S&P 500 consensus forward revenues edged down w/w for the first time in five weeks to 0.1% below its record high, and forward earnings fell for the first time in 23 weeks, albeit to less than 0.1% below its record high. The forward profit margin forecast remained steady at a record high of just under 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 at 5.2%, but 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 dropped to a 16-week low of 10.8% from 11.2% and is down from a six-month high of 11.3% in early July. It remains near January's 11.7%, which 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 forward growth rate forecasts for revenues (STRG) and earnings (STEG) for Industrials, Materials, Tech, and Utilities. However, Energy's contribution to forward growth peaked at the start of 2017. Looking at last week's results, the S&P 500 ex-Energy's STRG of 4.6% is 0.6ppt lower and STEG of 9.2% is 1.6ppts lower. However, the S&P 500 ex-Energy forward profit margin was at a record high of 11.6%, which is its first since August 2007. Valuation rose w/w to 17.9 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. On an ex-Energy basis, valuation rose to 17.5 from 17.3, which compares to a 13-year high of 17.6 in early March.

S&P 500 Sectors Earnings, Revenues & Valuation (*link*): Consensus forward revenue and earnings forecasts rose last week for five of the 11 sectors. Health Care and Materials 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 is at a nine-month low now after stalling for three months at a 15-month high, and its forward earnings is down from June's 21-month high to a seven-month low now. The forward P/S and P/E ratios rose w/w for 9/11 sectors (all but Financials and Telecom). Health Care has been surging recently; its P/E of 16.5 and P/S of 1.75 are near their highest levels since August 2015, but remain well below their early 2015 highs of 17.9 and 1.88, respectively. Financials' P/E is up from 12.0 before the election to 13.9, and is approaching the post-election high of 14.6 in early March. With Energy's forward revenues and earnings up from cyclical lows in early 2016, its valuations are coming 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 28.0 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 20.1% in 2017 from 19.2% in 2016), Real Estate (17.0, 25.2), Financials (15.6, 14.3), Telecom (11.3, 11.2), Utilities (10.9, 11.4), S&P 500 (10.6, 10.1), Health Care (10.4, 10.3), Materials (9.8, 9.4), Industrials (9.2, 8.9), Consumer Discretionary (7.3, 7.2), Consumer Staples (6.7, 6.5), and Energy (3.9, 1.2).

S&P 500 Q2 Earnings Season Monitor (*link*): With nearly 26% of S&P 500 companies finished reporting Q2-2017 results, their revenue and earnings surprise data are better than at the comparable point of the Q1 season, but y/y growth comparisons are mixed. Of the 128 companies in the S&P 500 that have reported, 73% exceeded industry analysts' earnings estimates by an average of 6.6%; they have averaged a y/y earnings gain of 16.0%. At the same point during the Q1-2017 reporting period, a higher percentage of companies (75%) in the S&P 500 had beaten consensus earnings estimates by a lower 6.0%, and earnings were up a lower 11.7% y/y. On the revenue side, 72% beat sales estimates so far, with results coming in 1.3% above forecast and 3.8% higher than a year earlier. At this point in the Q1 season, a lower 63% had exceeded forecasts, companies reported revenues a lower 0.9% above forecast, and sales rose a slightly higher 4.4% y/y. Q2 earnings results are higher for 67% of companies vs 75% at the same point in Q1, but revenues are higher for 81% vs 79% a quarter ago. Although these figures will change markedly as more Q2-2017 results are reported in the coming weeks, the early results are encouraging. Q2-2017 should mark the fourth straight quarter of positive y/y earnings growth, but growth is likely to fall back into the single digits following Q1's double-digit percentage growth, which was the first double-digit growth seen since Q3-2011.

US ECONOMIC INDICATORS

Consumer Confidence (*link*): Consumer confidence unexpectedly rose in July as a strong job market trumped Washington's gridlock. The Consumer Confidence Index rose to 121.1—the second-highest reading in 16 years, surpassed only by March's 124.9—after revisions showed a slight dip (rather than rise) in June. July's advance was driven by continued increases in the present situation component (to 147.8 from 143.9) to new cyclical highs, while the expectations component rose for the first time in four months, to 103.3, after falling from 112.3 in March to 99.6 in June. Consumers viewed the current job market very favorably, with those saying jobs are plentiful (to 34.1% from 32.0%) climbing to yet another new cyclical high and those saying jobs are hard to get (18.0 from 18.4) sinking to another new cyclical low. Consumers' six-month job outlook remained favorable, with the percentage expecting more jobs unchanged at 19.2% and those expecting fewer jobs falling from 14.6% to 13.3%. The spread remained positive for the ninth straight month.

Regional M-PMIs (*link*): Three Fed districts so far have reported on manufacturing activity for this month—New York, Philadelphia, and Richmond—and they show growth in the sector slowed after improving in June. We average the composite, orders, and employment measures as data become available. The composite index sank to 14.4 in July after climbing from 13.6 to 19.5 in June; it was at 27.0 in February—which was the highest reading since May 2004. The New York (to 9.8 from 19.8) measure eased after moving from contraction to expansion in June, while Philadelphia's (19.5 from 27.6) fell to a low for this year; Richmond's (14 from 11), on the other hand, showed faster growth during the month. The new orders gauge dropped to 11.1 after rebounding from 7.7 to 19.2 in June, as Philadelphia billings (2.1 from 25.9) slowed to a near standstill, while Richmond's (18 from 14) and New York's (13.3 from 18.1) held near recent highs, with growth in the former accelerating and the latter decelerating. The employment measure slowed for the fourth month from April's cyclical high of 14.8 to 8.3 this month, though Philadelphia (10.9 from 16.1) and Richmond (10 from 6) manufacturers continued to expand payrolls at a solid pace, while growth in New York hirings (3.9 from 7.7) slowed to a five-month low.

GLOBAL ECONOMIC INDICATORS

Germany Ifo Business Climate Index (*link*): "Sentiment among German businesses is euphoric," Ifo chief Clemens Fuest said. "Germany's economy is powering ahead." German businesses confidence in July posted its third record high in as many months as both the current situation and outlook continued to brighten. The Ifo business climate index advanced for the sixth consecutive month from 110.0 in January to 116.0—the highest in the history of the survey going back to 1991. Business assessment of the current situation hasn't posted a decline in 12 months, climbing from 113.2 in August to 125.4 in July, also the highest in survey history. The expectations component is still trending higher, rising from 103.2 at the start of the year to 107.3 this month—the highest since February 2014. Industry data show the Ifo sub-index for manufacturing jumped as manufacturers expect "exports to rise significantly"; the construction and wholesaling sectors also saw morale rise, while sentiment fell only in the retail sector. Ifo's expectations component correlates closely with German factory orders and production; the overall index tracks exports more closely. Recent Ifo data predict a continued acceleration in German activity.

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