MORNING BRIEFING
August 1, 2017

Money Talks

See the collection of the individual charts linked below.

(1) Sleepless in New Haven. (2) Getting a majority vote. (3) Too many bulls again? (4) Equity ETFs: The new black hole? (5) No need for a sales pitch as bullish ETF investors come charging through the doors. (6) Global equity ETFs on a roll. (7) Much of US stocks' underperformance is due to the weaker dollar. (8) Fed Vice Chair Fischer on stage with same act on real interest rates. (9) Might rapid technological innovation explain weakness in productivity and capital spending?

Strategy I: The YRIs Have It! Yardeni Research is having more success in getting a majority vote than are Senate Republicans. CNBC posted an article titled "Market 'melt-up' could push stocks to new records, including an S&P 500 rally of 8%." I was quoted extensively based on a telephone interview I had on Friday with my friends over there. I reiterated my view that the melt-up in stock prices this year is being driven by a melt-up in earnings, with our S&P 500 target at 2700 by mid-2018. Taking the opposing side in the debate was none other than Nobel Laureate and Yale University Economics Professor Robert Shiller. Poor guy is having trouble sleeping at night. He said he will "lie awake worrying" about the stock market:

"We have seen phenomenal earnings growth right now. Analysts are forecasting a continuation of that. So, I don't know what is driving earnings. I would be skeptical that they would continue at such a blistering pace. History shows that big earnings increases like this have a tendency to revert to trend."

At the bottom of the article is a neat feature allowing for a straw poll. The question posed was: "Do you believe an 'earnings melt-up' scenario will drive stocks higher into next year? After yesterday's close, the vote was 51% "Yes," 30% "No," and 19% "Maybe." It reflected the views of 4,933 voters.

From a contrarian perspective, that's somewhat bearish. So is the extreme bullishness reflected in last week's Investor Intelligence Bull/Bear Ratio (*Fig. 1*). The BBR recently jumped from 2.69 during the week of July 11 to 3.65 during the week of July 25. The good news is that this ratio works better as a bullish contrary indicator when it is below 1.0 than as a bearish contrary indicator when the ratio exceeds 3.0 (*Fig. 2* and *Fig. 3*).

Strategy II: Follow the Money. Many years ago, Dennison Clothes in Union, New Jersey ran radio ads on WABC in New York with the catchy tagline: "Money talks, nobody walks." The purveyors of equity ETFs don't need any sales pitch apparently. June's data from the Investment Company Institute show that the money continues to pour in their doors:

(1) *Equity mutual funds and ETFs.* During June, all equity funds attracted $42.5 billion, with $32.9 billion flowing into ETFs and the remaining $9.6 billion going into equity mutual funds (*Fig. 4*). Over the past 12 months through June, equity ETFs have attracted an astonishing $357.8 billion, which is a record for them, while equity mutual funds have seen $119.8 billion walk out the door (*Fig. 5*).

(2) *Domestic vs global ETFs.* The record inflows into equity ETFs over the past 12 months through June have been led by ETFs investing in domestic equities, with inflows of $236.2 billion (*Fig. 6*).

However, in recent months there has also been a remarkable flood of money running into equity ETFs that invest globally, with the 12-month inflow soaring to a record $121.6 billion.

(3) *Bond funds.* So far there has been no "great rotation" out of bond funds into equity funds. Over the past 12 months through June, bond funds attracted $378.3 billion, led by mutual funds ($273.4 billion) and followed by a record inflow into bond ETFs ($104.8 billion) (*Fig. 7*).

(4) *Massive monies.* In other words, the stock market melt-up is being driven by melt-ups in earnings and in equity ETF fund inflows. There has been a mini-rotation out of equity mutual funds into equity ETFs. However, on balance, money is pouring into both equity and bond funds at a prodigious pace. Over the past 12 months through June, money market mutual funds had net outflows of $13.6 billion, savings deposits rose $499.7 billion, and all equity and bond mutual funds and ETFs attracted $616.3 billion—for a grand total of $1.1 trillion (*Fig. 8*).

Global Economy: Mutual Attraction. While we are counting all the spare change going hither and thither, one of the bottom lines of our analysis is that all equity funds flows are showing a strong preference for global ones, with a net inflow of $158.5 billion over the past 12 months, over domestic ones, with a net inflow of $79.6 billion (*Fig. 9*). That's because despite their outperformance so far this year, foreign equities remain relatively cheap compared to US equities, especially as foreign economies have been surprising on the upside whereas US economic growth has remained lackluster and somewhat disappointing overall.

Joe and I have been in the Stay Home camp since early in the current bull market. However, we backed off late last year, seeing merit in the Go Global approach for the time being. Consider the following developments:

(1) *Performance.* On a ytd basis through Friday's close, the US MSCI has actually beat most of the other major indexes in local currency terms: Emerging Markets (18.3%), US (10.6), EMU (7.4), Japan (5.2), and UK (3.2). It has mostly underperformed in dollar terms: Emerging Markets (23.2), EMU (19.5), Japan (11.1), US (10.6), and UK (9.6) (*Fig. 10* and *Fig. 11*).

(2) *Valuation.* The US remains relatively expensive according to the latest forward P/E derby as of July 20: US (18.2), UK (14.6), EMU (14.4), Japan (14.3), and Emerging Markets (12.5) (*Fig. 12*).

(3) *Earnings.* The forward earnings of the US MSCI continues to rise into record-high territory (*Fig. 13*). Languishing from 2011 through 2015, the forward earnings of the All Country World Ex-US MSCI is showing signs of a solid cyclical recovery since early last year.

The Fed: Same Old Song. It must be lots of fun being Fed Vice Chair. You get to go to fun places; all you have to do is dust off your speech on "The Low Level of Global Real Interest Rates." That's the one Stanley Fischer delivered yesterday at the Conference to Celebrate Arminio Fraga's 60 Years, Casa das Garcas, Rio de Janeiro, Brazil. Sounds like a blast! Arminio had been the president of the Central Bank of Brazil from 1999 to 2002. He must be pleased that he hasn't had anything to do with Brazil's economic and financial debacle of the past several years, which Sandra Ward recapped for us in the 7/13 *Morning Briefing.*

Fischer addresses two questions that have been on his mind for a while, and that he has discussed in many recent speeches: "Why are interest rates so low? And why has the decline in interest rates been so widespread?" I think the short answer might be: "Because you and the other major central banks have kept them this low." However, Fischer has a longer answer:

(1) Fischer rightly observes that actual inflation has been remarkably low and subdued around the world. This has kept inflationary expectations low, along with "credible central back inflation targets."

(2) He also observes the obvious: "[T]he coincidence of low inflation and low interest rates suggests that the natural [real] rate of interest is likely very low today."

(3) Fed researchers have found that the real interest rate has dropped 150bps since the financial crisis of 2008, and may be only 50bps currently. This decline seems to have occurred in a number of foreign economies.

(4) The declines might be temporary if they were mostly caused by a preference for safe assets after the crisis along with central banks' QE programs, which should "fade over time."

(5) For the US, Fischer sees "three interrelated factors that are likely contributing to low interest rates: slower trend economic growth, an aging population and demographic developments, and relatively weak investment." Slower economic growth has been attributable to disappointing growth in productivity and the secular slowdown in the growth rate of the labor force.

(6) Interestingly, Fischer believes that capital spending has been depressed by political and economic uncertainty, especially about health care reform, deregulation, tax reform, and trade. Of course, these uncertainties have been heightened by the Trump administration. However, these were not major uncertainties for the eight years under the Obama administration, which is when the slowdown occurred.

A more interesting idea proposed by Fischer for the weakness in capital spending is that the pace of technological innovation is disrupting the "viability of long-standing business models," which could be weighing on investment decisions.

(7) Fischer seems to endorse the Greenspan/Bernanke thesis of a global savings glut. His spin is that slower US economic growth has reduced the demand for foreign funds, which are keeping interest rates even lower than when the housing bubble was inflating prior to the 2008 financial crisis.

(8) Fischer worries that low interest rates can have adverse consequences, including increasing the risks of liquidity traps and financial instability if the low rate environment "leads investors to reach for yield or hurts financial firms' profitability."

(9) Fischer concludes by asking, "What, if anything, can be done about low interest rates?" Not much, as far as monetary policy goes. It's really up to fiscal and regulatory policies, according Fischer.

The conclusion is that Fischer and other Fed officials have concluded that interest rates are likely to stay low and that they can't normalize rates in the ways they had in the past.

CALENDARS

US. Tues: Personal Income & Spending 0.4%/0.1%, Headline & Core PCED 1.3%/1.4% y/y, ISM & Markit M-PMIs 56.4/53.2, Motor Vehicle Sales 16.8mu, Construction Spending 0.5%. **Wed:** ADP Employment 175k, MBA Mortgage Applications, EIA Petroleum Status, Treasury Refunding Announcement. (Bloomberg estimates)

Global. Tues: Eurozone GDP 0.6%q/q/2.1%y/y, Eurozone, Germany, France, and Italy M-PMIs 56.8/58.3/55.4/55.1, UK M-PMI 54.5, Germany Unemployment Change & Unemployment Rate -

5k/5.7%, China Caixin M-PMI 50.4, RBA Rate Decision 1.50%. **Wed:** Japan Consumer Confidence 43.5. (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 by 1.1% during the two weeks ending July 22, after falling six of the prior seven weeks by 3.6%; it's within 2.6% of its record high recorded nine weeks ago. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). Our BBB climbed 1.2% over the two-week period, after contracting 4.5% over the prior seven-week period; it's 3.3% below its record high posted during the week of May 20. Jobless claims was unchanged at 244,000 (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—has moved higher again in recent sessions. Meanwhile, the WCCI climbed for the second week, by a total of 3.4%, after falling during five of the previous six weeks by a total of 8.2%.

S&P 500/400/600 Forward Earnings (*link*): LargeCap's forward earnings returned to a record high last week after dropping last week for the first time in 23 weeks. MidCap's rose to a record for a 24th week, but SmallCap's edged down for the first time in 14 weeks to 0.1% from a record last week. Momentum remains strong as the yearly change in forward earnings is up from six-year lows in early 2016, but the easy y/y comparisons may be waning. In the latest week, LargeCap's forward earnings was up 9.4% y/y, down from 9.6% a week earlier, and compares to a 64-month high of 10.2% 12 weeks ago and a six-year low of -1.8% in October 2015; MidCap's was steady at 13.0% y/y, which compares to a 65-month high of 13.2% in late June and six-year low of -1.3% in December 2015; and SmallCap's dropped to 12.6% from a 39-month high of 13.0%, which compares to a six-year low of 0.3% in December 2015. Consensus growth rates expected for 2017 and 2018 are edging lower now, but should improve if the corporate tax rate changes: LargeCap 11.1% and 11.3%, MidCap 10.6% and 13.7%, and SmallCap 9.4% and 18.9%.

S&P 500/400/600 Forward Valuation (*link*): Forward P/E ratios were mostly steady for the 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 was steady at a 19-week high of 17.7, which compares to 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 down to 18.1 from a six-week high of 18.2, 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 was steady at a six-week high of 19.2, which compares to a recent high of 19.7 in early June and 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 1.97 is at a new record high, while MidCap's 1.32 is close to its record high of 1.37 in late February. SmallCap's 1.01 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*): Q3 earnings estimates for the 11 S&P 500 sectors were mixed last week as analysts adjustments picked up following Q2 earnings results. The Q3 consensus fell w/w for eight of the 11 S&P 500 sectors, and rose for three. Telecom rose 0.6% w/w, ahead of Consumer Staples (0.4%) and Tech (0.4). Sectors with the biggest w/w decline in their Q2 forecast: Energy (-12.2), Materials (-3.2), and Real Estate (-1.6). The S&P 500's Q3-2017 EPS forecast fell 19 cents w/w to $33.41, and is down 1.2% from $33.82 at the end of Q2. That represents a forecasted pro forma earnings gain for Q3-2017 of 7.5% y/y, down from Q2's blended 10.8% and Q1's 15.3%, which was the strongest growth since Q3-2011 owing mostly to easier comps for Energy. The Q3-2017 forecast is down from 7.7% a week earlier, and down from 8.7% at the end of Q2. Since the end of Q2, Q3 estimates are lower for seven sectors and higher for two. Tech's Q3 forecast has risen 0.5%, Telecom's is up 0.2%, and both Consumer Staples and Industrials are unchanged. Energy's has tumbled 15.0% for the worst decline, followed by the Q3 forecasts for Materials (-3.4), and Consumer Discretionary (-1.7). The S&P 500's Q3-2017 forecasted earnings gain of 7.5% y/y would be its fifth straight gain after four declines. Ten of the 11 sectors are expected to record positive y/y earnings growth in Q3-2017, but only three are expected to beat the S&P 500's forecasted y/y earnings gain of 7.5%. That's because analysts expect Energy to report another large profit jump in Q3 relative to very low earnings a year ago. Still, that matches the 10/11 sectors that rose y/y on a blended basis during Q2-2017 and in Q1-2017. The latest forecasted Q3-2017 earnings growth rates vs their blended Q2-2017 growth rates: Energy (129.0% in Q3 vs a 532.3% in Q2), Tech (8.7% vs. 14.2%), Industrials (8.1, 7.4), S&P 500 (7.5, 10.8), Financials (6.2, 12.4), Materials (5.1, 7.1), Health Care (5.0, 6.6), Consumer Staples (4.8, 4.3), Real Estate (4.2, 4.2), Consumer Discretionary (3.0, 2.7), Utilities (0.4, -2.8), and Telecom (-1.1, -4.8).

S&P 500 Q2 Earnings Season Monitor (*link*): With 58% of S&P 500 companies finished reporting Q2-2017 results, their revenue and earnings surprise data and y/y growth comparisons are mixed compared to the comparable point of the Q1 season. Of the 290 companies in the S&P 500 that have reported through noon yesterday, 72% exceeded industry analysts' earnings estimates by an average of 5.8%; they averaged a y/y earnings gain of 19.2%. At the same point during the Q1-2017 reporting period, a higher percentage of companies (79%) in the S&P 500 had beaten consensus earnings estimates by a higher 6.9%, and earnings were up a lower 9.6% y/y. On the revenue side, 70% beat sales estimates so far, with results coming in 1.4% above forecast and 5.9% higher than a year earlier. At this point in the Q1 season, a lower 64% had exceeded forecasts, companies reported revenues a lower 0.7% above forecast, and sales rose a higher 8.1% y/y. Q2 earnings results are higher for 68% of companies vs 75% at the same point in Q1, but revenues are higher for 81% vs 79% a quarter ago. These figures will change markedly as more Q2-2017 results are reported in the coming weeks, but the early results are encouraging and suggest a return to more normalized growth rates following the Energy recession of 2015-2016. Q2-2017 should mark the fourth straight quarter of positive y/y earnings growth, but we expect growth will fall back into the single digits following Q1's double-digit percentage earnings growth, which was the first double-digit quarter seen since Q3-2011.

US ECONOMIC INDICATORS

Regional M-PMIs (*link*): Five Fed districts now have reported on manufacturing activity for this month—New York, Philadelphia, Richmond, Kansas City, and Dallas—and they show growth in the sector held close to June's pace. We average the composite, orders, and employment measures as data become available. The composite index edged down to 14.0 in July after climbing from 13.2 to 16.9 in June, with all regions continuing to show healthy growth. 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; gauges for Dallas (16.8 from 15.0), and Richmond (14 from 11), on the other hand, showed faster growth during the month, while Kansas City's (10 from 11) virtually matched June's pace. The new orders index slipped to 11.9 after rebounding from 10.0 to 14.3 in June, as Philadelphia billings (2.1 from 25.9) slowed to a near standstill while New York's (13.3 from 18.1) held near recent highs. Meanwhile, billings in the Richmond (18 from 14), Dallas (16.1 from 9.6), and Kansas City (10 from 4) regions all showed faster growth. The employment measure slowed for the fourth month, though not by much, from March's cyclical high of 13.1 to 10.2 in July. Kansas City (unchanged at 15), Dallas (11.2

from 9.6), Philadelphia (10.9 from 16.1), and Richmond (10 from 5) 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.

Pending Home Sales (*link*): The Pending Home Sales Index—measuring sales contracts for existing-home purchases—rose in June for the first time in four months, rebounding 1.5% to 110.2. Sales were up 0.5% y/y after falling below year-ago levels the previous two months. According to NAR's chief economist, "Market conditions in many areas continue to be fast paced, with few properties to choose from, which is forcing buyers to act almost immediately on an available home that fits their criteria. Low supply is an ongoing issue holding back activity." Housing inventory last month was a staggering 7.1% below a year ago. Regionally, sales rose everywhere but the Midwest (-0.5% m/m, -3.4% y/y) in June, while the Northeast (0.7, 2.9) and South (2.1, 2.6) were the only regions with sales above year-ago levels; sales in the West rose 2.9% m/m, but fell 1.1% y/y.

GLOBAL ECONOMIC INDICATORS

Eurozone CPI Flash Estimate (*link*): July's CPI rate is expected to be unchanged at 1.3% y/y, remaining 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 2.2% from 1.9% y/y) is expected to have the highest annual rate, accelerating from June's five-month low; the non-energy industrial goods (0.5 from 0.4) rate continued to climb from its recent low of 0.2% in February, though has remained below 1.0% since April 2013. Meanwhile, the services rate (1.5 from 1.6) eased slightly, while the rate for food, alcohol, and tobacco (1.4) was unchanged at its low for this year. The core rate—which excludes energy, food, alcohol, and tobacco (1.2% from 1.1%)—is expected to increase slightly, back up to April's rate, 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