# MORNING BRIEFING
**August 2, 2017**

## Call of the Wild

*See the collection of the individual charts linked below.*

(1) Raising odds of the Melt-Up scenario. (2) A dog named "Buck." (3) Klondike Gold Rush in stock market. (4) Going feral. (5) Fidelity cutting fees, while Schwab opens lots of accounts. (6) Swamped by another fiscal cliffhanger? (7) M-PMI and weak dollar are bullish for revenues. (8) Can the Fed hit a bullseye on inflation target? (9) Sticky CPI suggests that underlying inflation is higher than shown by PCED.

**Strategy I: Going Feral.** The *Call of the Wild* is a short adventure novel by Jack London. It was published in 1903 and set in Yukon, Canada during the 1890s Klondike Gold Rush. The central character of the novel is “Buck,” a large and powerful, but domesticated, St. Bernard-Scotch Shepherd dog. Buck is stolen from his home at a ranch in Santa Clara Valley, California, and sold to be a sled dog in Alaska. He becomes increasingly wild as he is forced to fight to survive and dominate other dogs. By relying on his basic instincts, he emerges as a leader in the pack.

This story seems to portray current developments in the White House and, more broadly, in Washington, DC. It also captures the essence of what we may be starting to see in the stock market. Following the stock market debacles of the early and late 2000s, retail investors retreated from the stock market and turned relatively domesticated, with more of their savings going into liquid assets and bonds. Since Election Day, they seem to have heard the call of the wild. Their feral instincts have been awakened, triggering a gold rush into both domestic and global stock markets.

As Debbie and I reviewed yesterday, over the past 12 months through June, a record $357.8 billion has poured into equity ETFs, led by $236.2 billion going into domestic ETFs and $121.6 billion going into ETFs that invest globally (*Fig. 1*). All three inflows are at, or near, recent record highs. Admittedly, some of these inflows came from equity mutual fund outflows, particularly from domestic ones (*Fig. 2*). However, that could be the call of the wild convincing investors that the stock market is going higher regardless, so they are ditching managed funds for passive ones with cheaper management fees. Consider the following developments:

(1) *For a few dollars less.* Apparently, Fidelity Investments has heard the call of the wild. The provider of both active and index investment products is lowering fees on 14 of its 20 stock and bond mutual funds as of yesterday. The average expenses across Fidelity’s stock and bond index fund lineup will decrease to 9.9 basis points, down from 11 basis points. The expense reductions are expected to save current shareholders approximately $18 million annually, Fidelity said.

(2) *Gold rush.* In a July 18 earnings conference call, Walt Bettinger, the CEO of Charles Schwab, said, “Strong client engagement and demand for our contemporary approach to wealth management have led to business momentum that ranks among the most powerful in Schwab’s history. Equity markets touched all-time highs during the second quarter, volatility remained largely contained, short-term interest rates rose further, and clients benefited from the full extent of the strategic pricing moves we announced in February. Against this backdrop, clients opened more than 350,000 new brokerage accounts during the second quarter, bringing year-to-date new accounts to 719,000—up 34% from a

year ago and our strongest first half total in seventeen years."

(3) *The howling.* All this supports our howling about a possible melt-up since early 2013—when Washington didn't push the economy off a fiscal cliff, as was widely feared, though not by us. We started to argue back then that the bull market was more likely to end with a melt-up before there was any meltdown.

Today, we are raising the odds of the Melt-Up scenario from 40% to 50%. The Meltdown scenario remains at 20%, while the Nirvana scenario gets cut from 40% to 30%. By the way, a melt-up followed by a meltdown won't necessarily cause a recession. It might be more like 1987, creating a great buying opportunity, assuming that we raise some cash at the top of the melt-up's ascent. Our animal instincts will have to overcome our animal spirits, I suppose.

(4) *The swamp.* The stock market might continue to melt up during the remaining dog days of summer, blissfully ignoring the swamp people in Washington, who are mostly away on vacation. Unfortunately, they'll be back. The Senate and House have 12 joint working days before September 29, when the Treasury Department would no longer be able to pay all of the government's bills unless Congress acts. A default could set off turmoil in world financial markets.

Talks among Treasury Secretary Steven Mnuchin, Senate Majority Leader Mitch McConnell, and Senate Minority leader Charles Schumer broke up Tuesday morning with no progress on raising the country's debt ceiling, an impasse that could threaten yet another fiscal cliff cliffhanger for the financial markets. That may turn out to be yet another buying opportunity. Stay tuned.

**Strategy II: Fundamentally Sound.** Our Blue Angels analysis of the S&P 500/400/600 shows that the bull market has been powered by a combination of rising forward P/Es and forward earnings (*Fig. 3*). The former are at or near cyclical highs, while the latter are all at record highs (*Fig. 4* and *Fig. 5*). If stocks are on the verge of a melt-up, then most of the gains will be led by the P/Es.

As Joe and I noted last week, a fast ascent in stock prices isn't really a stock market melt-up if it is led by rising earnings, which has been the story so far this year. However, there is a natural limit to how fast earnings can rise, which is determined by the growth of the economy. There is no natural limit to the P/E, as was demonstrated by the insane valuation of technology stocks in the late 1990s. Could a meltdown occur as a result of valuations getting too high even if the earnings outlook remains constructive? Of course. Indeed, that's what happened in 1987. For now, we can say that the earnings outlook remains positive:

(1) *M-PMI and revenues*. As Debbie reports below, the M-PMI edged down from 57.8 in June to 56.3 in July (*Fig. 6*). That's still high and consistent with S&P 500 revenues growth of about 5.0%.

(2) *The dollar.* Not surprisingly, there is an inverse correlation between the trade-weighted dollar and S&P 500 revenues, both on a y/y percent change basis (*Fig. 7*). The former has been positive since mid-2014, which is negative for revenues. At the end of July, the trade-weighted dollar was down 1.9% y/y, which should be modestly positive for both revenues and earnings.

**The Fed: Target Practice.** The FOMC can't seem to hit a bullseye. It's been targeting inflation since the January 24-25, 2012 meeting of the Fed's monetary policy committee. For the first time, it set an official inflation target: "The Committee judges that inflation at the rate of 2 percent, as measured by the annual change in the price index for personal consumption expenditures [PCED], is most consistent over the longer run with the Federal Reserve's statutory mandate." The headline PCED inflation rate rose 1.4% y/y during June, while the core (excluding food and energy) increased 1.5% (*Fig. 8*).

Only briefly at the start of this year has the FOMC hit a bullseye since they started target practice in early 2012. Melissa and I believe that the ability of monetary policy to target inflation is over-rated since monetary policy isn't the only important factor influencing inflation. Competition, technology, demography can be just as important, if not more important.

Since April 27, 2011, Fed officials have been projecting both the headline and the core PCED in the Summary of Economic Projections (SEP) compiled and released quarterly by the FOMC. Prior to 2000, the FOMC focused on the CPI. Melissa, our Fed sleuth, found a footnote in the committee's February 2000 *Monetary Policy Report* (*MPR*) to Congress explaining the switch in preference to the PCED from the CPI. It stated:

"In past Monetary Policy Reports to the Congress, the FOMC has framed its inflation forecasts in terms of the consumer price index. The chain-type price index for PCE draws extensively on data from the consumer price index but, while not entirely free of measurement problems, has several advantages relative to the CPI. The PCE chain-type index is constructed from a formula that reflects the changing composition of spending and thereby avoids some of the upward bias associated with the fixed-weight nature of the CPI. In addition, the weights are based on a more comprehensive measure of expenditures. Finally, historical data used in the PCE price index can be revised to account for newly available information and for improvements in measurement techniques, including those that affect source data from the CPI; the result is a more consistent series over time."

Nevertheless, the report noted that the FOMC would "continue to rely on a variety of aggregate price measures, as well as other information on prices and costs, in assessing the path of inflation." None of the alternative measures is ideal, giving the committee some flexibility for policy-making. The inflation derby based on the latest data for a selection of inflation measures is as follows: median CPI (2.2% y/y), sticky CPI (2.1), trimmed-mean CPI (1.9), core CPI (1.7), trimmed-mean PCED (1.7), headline CPI (1.6), core PCED (1.5), and headline PCED (1.4). Notice that the "skinnier" measures of inflation, which exclude the more volatile price categories, currently happen to fall at the top end of the range. Let's review some of the alternative targets:

(1) *CPI*. The headline and core CPI inflation rates were 1.6% and 1.7% during June (*Fig. 9*). There are three main differences between the CPI and PCED measures: weight, scope, and formula. They use different baskets of goods and services with different weights for the included items. The relative weights for the CPI, prepared by the Bureau of Labor Statistics (BLS), are based on surveys of consumers, and the PCED, prepared by the Bureau of Economic Analysis, reflects surveys of businesses. It is known that response rates are higher and response quality is better for businesses than household surveys, noted a 2007 BLS and BEA joint paper.

Regarding scope, the CPI only covers out-of-pocket expenditures for urban consumers. The PCED more broadly includes other expenditures, such as medical care paid for by employer insurance, Medicare, and Medicaid. More broadly, the PCED coverage includes "the goods and services purchased by households and non-profit institutions serving households within the framework of the U.S. national income and product accounts," according to the BLS and BEA joint paper. Finally, the price changes for the baskets are calculated using different formulas. The PCED formula tries to account for substitution between goods when one good gets more expensive. The basket doesn't change for the CPI.

The core PCED inflation rate has been consistently lower than the comparable CPI rate (*Fig. 10*). That's mostly because rent, which has been rising more rapidly than other prices, has a higher weight in the CPI and the prices of healthcare outlays paid by the government are excluded.

(2) *Trimmed-mean (FRB Cleveland)*. Trimmed-mean inflation measures remove the most volatile monthly price changes from the inflation calculation (*Fig. 11*). The authors of a 2014 Cleveland Fed *Working Paper* explained: "These measures systematically remove sources of noise on a monthly basis, rather than ad hoc exclusionary measures such as the ex food and energy ('core') CPI which implicitly suggests that relative price changes in all other retail price components are [an] inflation signal, even though food prices are no more volatile than the core CPI itself."

(3) *Median (FRB Cleveland)*. The median CPI is considered to be an "extreme trim" measure. As the first step for calculating the median, the FRB Cleveland groups the array of consumer items into 45 categories. For each category, the percent change in the price is calculated for each month and is seasonally adjusted and annualized. On that basis, each category is sorted from highest to lowest. Each category is also weighted according to its relative importance. The median CPI is determined as the middle point where the cumulative relative importance reaches the 50% threshold.

(4) *Sticky CPI (FRB Atlanta)*. The sticky CPI is just another way to strip out the noise from the inflation data. "[S]ome prices are 'sticky,' which means that they may not respond to changing market conditions as quickly as other more 'flexible-price' goods. And because sticky prices are slow to change, it seems reasonable to assume that when these prices are set, they incorporate expectations about future inflation to a greater degree than prices that change on a frequent basis," as outlined a 2010 FRB-CLE *Economic Commentary*.

The 12-month annualized sticky CPI was 2.1% y/y during June. It has been above 2.0% consistently since October 2014. Meanwhile, the comparable measure for items with flexible prices was just 0.5%. That supports the view of Fed Chair Janet Yellen that current downward pressures on inflation are likely transitory. Lower flexible prices are depressing overall inflation, while sticky prices are steadily holding it up.

## CALENDARS

**US. Wed:** ADP Employment 175k, MBA Mortgage Applications, EIA Petroleum Status, Treasury Refunding Announcement. **Thurs:** ISM & Markit NM-PMIs 56.9/54.2, Jobless Claims 244k, Weekly Consumer Comfort Index, Challenger Job-Cut Report, EIA Natural Gas Report. (Bloomberg estimates)

**Global. Wed:** Japan Consumer Confidence 43.5. **Thurs:** Eurozone Retail Sales 0.0%m/m/2.5%y/y, Eurozone, Germany, France, and Italy Composite PMIs 55.8/55.1/55.7/54.9, Eurozone, Germany, France, and Italy Non-Manufacturing PMIs 55.4/53.5/55.9/54.1, UK Composite & Non-Manufacturing PMIs 53.8/53.6, Japan & China Composite & Non-Manufacturing PMIs, BOE Rate Decision 0.25%, BOE Asset Purchase Target 435b, BOE Inflation Report. (DailyFX estimates)

## STRATEGY INDICATORS

**S&P 500 Q2 Earnings Season Monitor** (*link*): With over 62% 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 312 companies in the S&P 500 that have reported through noon yesterday, 71% exceeded industry analysts' earnings estimates by an average of 5.7%; they averaged a y/y earnings gain of 14.3%. 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, 69% beat sales estimates so far, with results coming in 1.2% above forecast and 5.5% 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 64% of companies vs 75% at the same point in Q1, but revenues are higher for 83% vs 79% a quarter ago. The widening gulf between the percentage of companies reporting higher y/y earnings growth and those reporting higher y/y revenue growth suggests that margins may be under pressure. As more Q2-2017 results are reported in the coming weeks, the surprise figures will continue to change, but the results to date suggest a return to more normalized growth rates following the Energy recession of 2015-2016. Q2-2017 will 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

**Personal Income & Consumption** (*link*): Real consumer spending in June was flat, as a 0.1% gain in services consumption was offset by a 0.1% decline in goods consumption. Still, real PCE expanded 2.8% (saar) last quarter, accelerating from Q1's 1.9%, with goods consumption up 4.7% and services consumption 1.9% higher. Real wages & salaries rose for the sixth straight month to a new record high, climbing 0.3% in June and a robust 4.0% (saar) last quarter. Our Earned Income Proxy, which tracks wages & salaries and consumer spending closely, continued to set new record highs through July, suggesting that the consumer should continue to drive economic growth.

**Auto Sales** (*link*): Motor vehicle sales in July were little changed around June's 28-month low, holding below 17.0mu for the fifth consecutive month. Sales edged up to 16.7mu (saar) from 16.6mu in June, which was the lowest reading since February 2015. Sales are 1.4mu below the recent high of 18.1mu at the end of last year. Domestic car sales ticked up to 4.5mu (saar) from June's cyclical low of 4.3mu, which was the lowest reading since December 2011. Meanwhile, light truck sales ticked down from 8.9mu to 8.7mu (saar) last month, not too far from its cyclical high of 9.2mu in February. Sales of imports have fluctuated in a narrow band between 3.3mu and 3.7mu since spring 2015; these sales edged up from 3.4mu to 3.5mu (saar) in July.

**Construction Spending** (*link*): Construction spending dropped an unexpected 1.3% in June as public construction spending tumbled 5.4%—its biggest monthly drop in 15 years! Private construction spending declined for the third month, edging down 0.1% in June and 1.1% over the period, after soaring in 14 of the previous 15 months by a total of 14.3% to a new record high. Residential investment slumped 0.2% m/m and 1.4% over the three-month period, holding near March's cyclical high; meanwhile, nonresidential investment rebounded 0.7% in the two months through June after a four-month slide of 3.1%; it remains near its record high. Within residential investment, new single-family construction remains strong, increasing in eight of the past nine months by 10.2% to a new cyclical high. Weighing on residential investment the past few months was a 6.0% drop in new multi-family construction in the two months through June, while home-improvement spending was flat in June after a two-month loss of 3.5%; both remain near record levels.

## GLOBAL ECONOMIC INDICATORS

**Global Manufacturing PMIs** (*link*): Global manufacturing activity in July expanded at a three-month high, just below the pace during the first three months of the year. The JP Morgan M-PMI edged up to 52.7 in July from 52.6 the prior two months; it was at cyclical high of 53.0 during February and March. New orders (to 53.6 from 53.3) expanded at a faster pace last month, while both output (53.1 from 53.2) and employment (51.5 from 51.7) grew at a slightly slower pace. The developed nations (54.0 from 53.9) continued to record much stronger growth than emerging markets (50.9 from 50.8), though both grew slightly faster. Growth once again was led by the European nations—which accounted for eight of the 10 top-performing countries; Canada and Australia finished in the number four and 10 spots, while the US was in 14th place. Within Europe, Austria (60.0), the Netherlands (58.9), Germany (58.1), Italy (55.1), the UK (55.1), France (54.9), Ireland (54.6), and Spain (54.0) had the highest rankings. According to the report, around half of the Asian economies covered by the survey showed a contraction in July, including India (47.9), South Korea (49.1), Indonesia (48.6), Malaysia (48.3), Thailand (49.6), and Myanmar (49.1); only Taiwan (53.6) recorded both a solid and accelerated expansion in the region. China's (51.1) growth was slightly faster, though still marginal, while the Philippines (52.8), Japan (52.1), and Vietnam (51.7) showed slower growth.

**US Manufacturing PMIs** (*link*): Manufacturing activity in July held near June's cyclical high according to ISM's survey, while it grew at its fastest pace in four months according to Markit's. The ISM M-PMI slipped to 56.3 last month after jumping from 54.9 to 57.8 in June, which was the highest reading since August 2014. Nearly all the components showed a slight easing in July, though remained at high levels. The production (60.6 from 62.4) and new orders (60.4 from 63.5) measures held above 60.0, with the latter still being helped by strong export orders (57.5 from 59.5)—which continued to bounce around cyclical highs. The employment (55.2 from 57.2) gauge also fluctuated around its cyclical high, while the supplier deliveries (55.5 from 57.0) measure remained on a volatile uptrend. Meanwhile, the inventories (50.0 from 49.0) gauge was the outlier, moving out of contractionary territory. Markit's M-PMI rebounded to 53.3 after easing the prior five months from a 22-month high of 55.0 at the start of this year to a nine-month low of 52.0 in June. According to the report, the pickup in activity was driven by "marked and accelerated expansions in both output and new orders," while manufacturers added to payrolls at the fastest pace in five months. Meanwhile, business confidence reached a six-month high.

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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