MORNING BRIEFING
August 3, 2017

Sangria Summer

See the collection of the individual charts linked below.

(1) Tipping point. (2) Raving about Tesla. (3) Big frunk. (4) Tesla's competitors getting charged up too. (5) Banning diesel. (6) Auto stocks stalling along with sales. (7) Eurozone heating up this summer. (8) Spain firing on all cylinders. (9) Tourists are flooding Iberian Peninsula. (10) Upgrading Portugal. (11) PIIGS can fly!

Industry Focus: Electrifying Autos. It's often hard to tell when a tipping point has arrived. When the mobile phone was the size of a large brick and mounted in executives' cars, few would have guessed that in 30 years a much slimmer version would be considered de rigueur for 12-year-olds. Today it feels like Tesla's Model 3 may be tipping the scales in favor of electric cars. Unveiled on Friday to rave reviews, the Model 3 seems able to compete toe-to-toe with gas-powered cars, even if gas prices are low and tax incentives disappear. If nothing else, Tesla has sparked a race to see who will be able to produce the best electric car—and who can do so profitably. The Model 3's launch also gives governments the leeway to increase auto emissions requirements. I asked Jackie to look at some of these electrifying developments.

(1) *Superlatives abound*. Tesla delivered the first 30 of its new Model 3 cars on Friday to employees, and allowed a handful of reviewers to drive it. *Motor Trend's* reviewer called the car "the most important vehicle of the century" in a 7/28 article. She deemed the interior "incredibly light and airy," the trunk "yawning," and wrote: "The ride is Alfa Giulia (maybe even Quadrifoglio)–firm, and quickly, I'm carving Stunt Road like a Sochi Olympics giant slalomer, micrometering my swipes at the apexes." While written in car-aficionado code, it seems apparent that she liked the car.

The Model 3 "changes everything," enthused a Bloomberg 7/31 review. "We took one out for a spin, and have little doubt that the age of electric cars has arrived. … It's nimble, comfortable, and has tight steering that'll keep you grinning." The author believes the company is trying to compete with other $35,000 luxury cars, specifically the BMW 3 and the Mercedes-Benz C-Class—and it succeeds.

We went searching for negative reviews and came up empty. A 7/30 Quartz article put together a list of reviews, and all were glowing.

(2) *The specs*. Here are some of the car's most interesting highlights. The standard car, for $35,000, boasts the ability to drive 220 miles on one charge. Those willing to spend $44,000 can have a battery upgrade that extends the mileage to 310 miles on a charge. The Chevy bolt, for almost $38,000, gets 238 miles on a charge, and all other non-Tesla competitors get under 150 miles.

The Model 3 has nothing on the dashboard. All controls are handled by a 15.4-inch, flat touchscreen. Because the batteries are under the car, the Model 3 has a "frunk," a storage space in front of the car where a gasoline engine would normally go. And keys? They're so 1990s. The Model 3 synchs to your phone and unlocks as you approach. It also has a key card to give to a valet.

Another upgrade for $5,000: a roof made entirely of glass that protects against the sun like SPF 90. One reviewer notes that the back seats fold down, and some people are talking about sleeping in their cars instead of in a tent when camping. The glass roof would make for amazing star-gazing. In all, upgrades can boost the Model 3's price to almost $60,000, before tax credits.

(3) *The competition responds*. Automakers haven't been standing still as Tesla developed the Model 3. Many have their own offerings, and more are on the way, both to fend off Tesla and to meet upcoming tougher requirements on car emissions. Europe has a target for each new car to produce no more than 95 grams of carbon dioxide per kilometer by 2020, explained a 3/29 Reuters article.

Daimler plans 10 new all-electric cars, representing 15% to 25% of their product by 2022. The push will cost north of $10 billion. The news came after the company reported that it failed to cut its fleet emissions in Europe last year, blaming customers' preference for SUVs. "Last year the average fuel emissions remained at 123 grams for Mercedes-Benz Cars, the same level as in 2015," the article stated. "It is the first time since 2007 that it has failed to cut average pollution levels despite the introduction of more fuel-efficient engines throughout its range."

Chinese-owned Volvo announced all of its new models would either be fully electric or a hybrid from 2019, making it the first major auto manufacturer to abandon gasoline-powered engines. Its target: to sell 1 million electric cars and hybrids by 2025.

"Volvo also said it would launch five new electric and hybrid vehicles between 2019 and 2021. Two of the new models would be built by Polestar, the performance-car unit that Volvo is spinning off as a 'separately branded electrified global high-performance car company.' Volvo Cars would build the other three models," a 7/5 *WSJ* article reported. "Industry analysts estimate that rising costs of developing combustion engines that meet ever-stricter emissions regulations could make some electric models more affordable as soon as 2025."

Toyota Motors plans by the early 2020s to sell cars with solid-state batteries, a new type of battery that would roughly double the range of electric cars and cut the charging time, the 7/27 *WSJ* reported. The batteries wouldn't be as susceptible to cold weather, which can reduce the charge of a battery.

At Fiat Chrysler CEO Sergio Marchionne said the premium Maserati sports cars will offer electric-powered engines after 2019 and "by early next decade more than half of the brand's cars will be electrified," noted a 7/27 *WSJ* article.

(4) *Governments respond*. The recent embrace of battery technology has been hastened by the recall of diesel-engine powered cars in Europe, after they were shown to produce more emissions than previously believed. Software in the cars artificially reduced emissions during testing. Now car makers are scrambling for ways to meet Europe's stringent emissions regulations.

Even more dramatically, some cities and countries are banning diesel cars altogether. The UK announced a ban of sales of diesel and gasoline vehicles by 2040. Meanwhile, Athens, Paris, and Madrid have pledged to ban diesel vehicles by 2025.

Tesla may be delivering the right car at just the right time to make gas- and diesel-powered cars oh so last century. Not all is perfect, however. Tesla would have an easier sales pitch if the price of gasoline were approaching $4 a gallon instead of the $2.27 it fetches today (*Fig. 1*). The low price of gas has made cross-over vehicles and trucks far more popular than sedans. In addition, the company is burning through cash. Tesla had negative free cash flow of $1.8 billion in the first half of this year, including the $1.5 billion spent on capital expenditures. It plans to spend another $2 billion on cap ex during the remainder of 2017 and had $3 billion of cash on hand as of 6/30. This year alone, analysts forecast the company will lose $6.06 a share. Enthusiasm for the company's product and faith in its future will have to continue if Tesla aims to keep raising funds from the markets.

(5) *Stalling sales*. In the meantime, sales of traditional vehicles dropped 7% y/y last month, according to Autodata, as consumers opted against buying cars and instead purchased light trucks and as companies decreased discounts on leases and sales to rental fleets. The preference for light trucks accelerated in 2014 and continues today (*Fig. 2* and *Fig. 3*). Total vehicle sales slid 15.4% in July y/y at General Motors, 7.4% at Ford Motor, 10.5% at Fiat Chrysler Automotive, and 1.2% at Honda. The only company to buck the trend was Toyota, which saw sales rise 3.6% in July. The slowdown this year has left dealers' lots full as inventory levels climb (*Fig. 4*).

Tesla's looming shadow combined with the slowdown in gas-powered car sales has weighed on the S&P 500 Automobile Manufacturers stock price index, which is down 4.8% ytd through Tuesday's close (*Fig. 5*). Analysts are calling for industry revenues and profits each to fall 3.6% over the next 12 months (*Fig. 6*). While a forward P/E of 6.3 reflects the concerns about the auto industry, it still might not reflect a world where the tipping point for electric vehicles has arrived.

Europe I: 'Whatever it Takes' Took. If there were any questions about the strength and durability of the economic recovery in the Eurozone, they were laid to rest with the latest Q2 numbers released Tuesday showing that the region grew at the fastest pace since the Q2-2011 and posted its 17th straight quarter of growth.

The stellar results—five years after ECB President Mario Draghi famously declared a "whatever-it-takes" strategy to save the euro and launched a massive bond-buying program at the start of 2015 that now totals 2.3 trillion euros (US$2.6 trillion) to relieve the debt burden on the region's countries—increases the pressure on the ECB to pull back the punch bowl when it meets this autumn. Rate watchers will take heed of the July uptick in core inflation—excluding energy, food, and alcohol and tobacco—to 1.2% from 1.1% from the previous month, according to the flash estimate, as Draghi has said he is looking for a convincing upward trend in core inflation before raising rates and tapering the bond-buying.

The number-crunchers at the European Union's Eurostat agency reported GDP in the 19-country single-currency region rose 2.1% y/y and notched a gain of 2.4% (saar) from Q1. The growth comes amid a boom in manufacturing, increased tourism, higher exports, improving labor markets, and rising business and consumer confidence. Unemployment in the region dropped to 9.1%, its lowest level since February 2009.

Europe II: Touché, Brexit! All the sweeter: The pace of growth was twice that of the UK, where economic output grew by 1.2% (saar) in the three months ended June, up slightly from the sluggish 0.8% pace of Q1. No wonder the EMU is the second-best-performing major market index ytd in dollar terms through Tuesday's close, up 20.5%. Only the Emerging Markets turned in better performance, rising 24.0% (*Fig. 7* and *Fig. 8*).

It's instructive to look at two of the region's biggest success stories that were particularly hard hit in the financial crisis, Portugal and Spain, members of the so-called "PIIGS"—those countries on the periphery of Europe that also include Italy, Greece, and Ireland. Once among the Eurozone's biggest basket cases, Spain and Portugal are now the brightest stars in its firmament. I asked Sandra Ward, who recently joined us from *Barron's* as a contributing editor, to have a closer look.

First, to Spain, the regional standout:

(1) *GDP growth.* Spain's economy grew by 3.6% (saar) in Q2, triple that of the UK and nearly double the 2.2% rate of growth in France (*Fig. 9*). The expansion came on top of a 3.2% advance in Q1 and marks the 15th consecutive quarter of economic growth. Spain is now on track to deliver annualized growth of 3.1% this year, an impressive third straight year of plus-3.0% economic growth; that's the fastest of any of the major countries in the Eurozone, according to a 7/28 *NYT* article.

(2) *Exports.* Now only Germany produces and exports more cars than Spain in continental Europe, an astonishing fact noted in the *NYT* article. Exports—which include professional services, machinery, and pharmaceuticals—now represent 33% of Spain's $1.4 trillion GDP, according to World Bank data. That's up from 23% in 2009, and Q2 exports grew at the fastest rate since 2010 (*Fig. 10*). This is a far cry from Spain's economic picture early in the century, when the construction sector was the major contributor to GDP.

(3) *Manufacturing.* Spain's purchasing manager's index came in at a solid 54.0 in July, but it dropped from 54.7 in June for the weakest showing since March (*Fig. 11*). Total new order growth slowed for the second straight month to the lowest level since September 2016, and manufacturing production rose at the most sluggish pace in nine months, according to research collected by IHS Markit in its Purchasing Managers' Index survey. One explanation: Raw materials shortages reported by those Markit surveyed might have held back stronger

growth.

(4) *Jobs.* The unemployment rate in Spain now stands at 17.2%, the second highest in the EMU after Greece but the lowest that Spain's has been since 2008. The rate has been dropping steadily from a record high of 27% in 2013. In July, Spanish manufacturers hired at the fastest pace since May 1998 in order to meet production demand.

(5) *Tourism.* At 11% of Spain's GDP, tourism is a big deal … and getting bigger. The number of tourists visiting Spain rose 12% in the first half of the year, according to a 7/31 Associated Press story, to 36.3 million. This is the fourth year of record-breaking tourist levels in Spain.

(6) *Valuation.* Spain is the eighth-best performer among the MSCI country indexes ytd, up 29.3% in dollar terms (*Fig. 12*). Among Eurozone countries, only Greece, with a 30.9% gain, has done better. With earnings forecast to rise 11.2% this year and 9.9% next year, Spain still represents good value for investors despite a forward P/E of 13.7 times because earnings continue to be revised upward and profit margins are widening.

Now to Portugal:

(1) *Consumer confidence.* The Portuguese are more confident in the financial outlook for their country than they have been in the 20 years since economists started collecting consumer confidence data for Portugal, according to a 7/28 Reuters report based on the latest government statistics. July's reading of 2.5 was up from 1.7 in June. Both numbers took forecasters by surprise. Consumer confidence has been rising since 2013 but crossed into positive territory for the first time in May when it registered 0.1, again surprising economists (*Fig. 13*). There's a lot to be optimistic about: The economy is growing at the fastest rate in a decade and at twice the rate of the Eurozone on average in Q1.

(2) *GDP.* Portugal is set to deliver its strongest economic growth in more than two decades this year, as the Bank of Portugal lifted its growth targets sharply in June to 2.5%, from a previous forecast of 1.8% and up from 1.4% in 2016. This comes on the heels of a 2.8% y/y advance in Q1, its strongest performance in a decade, twice the rate of the Eurozone average. A strong export market, an improving investment climate, and tourism led to the revised numbers. In a 5/24 Reuters interview, Finance Minister Mario Centeno said he expected y/y growth in Q2 to be above 3%. He also asserted that economic growth would exceed 2% for the full year.

(3) *Budget deficit.* For the first time, Portugal is in compliance with the Eurozone's fiscal rules, with a budget deficit of 2.1% of its $204.6 billion GDP, below the 3% limit set by the European Union. As a result, in May the European Commission ended disciplinary procedures against the country.

(4) *Debt upgrade?* All the good news has led to a drop in Portugal's bond yields as it increasingly appears that the country's debt will be upgraded to investment-grade status from junk, based on the improving fundamentals.

(5) *Valuation.* Investors have been attracted to Portugal's improving outlook, making it one of

the best-performing markets in the week ended Tuesday, with a 3.2% gain (*Fig. 14*). It's up 16.2% ytd, right in line with its forward P/E (*Fig. 15*). But it appears to have gotten ahead of itself based on its short-term and long-term earnings growth rates of 5.5% and 7.6%, respectively (*Fig. 16*).

Maybe PIIGS can fly after all.

CALENDARS

US. Thurs: ISM & Markit NM-PMIs 56.9/54.2, Jobless Claims 244k, Weekly Consumer Comfort Index, Challenger Job-Cut Report, EIA Natural Gas Report. **Fri:** Total & Private Nonfarm Payroll Employment 178k/175k, Unemployment Rate 4.3%, Average Hourly Earnings 0.3%m/m/2.5%y/y, Average Workweek 34.5hrs, Merchandise Trade Balance -$44.4b, Baker-Hughes Rig Count. (Bloomberg estimates)

Global. 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. **Fri:** Eurozone Retail Sales, Germany Factory Orders 0.5%m/m/4.4%y/y, Canada Net Change in Employment & Unemployment Rate 10k/6.5%. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): There wasn't much movement in the Investors Intelligence sentiment numbers this week, following big moves in prior weeks. Our Bull/Bear Ratio (BBR) ticked up to 3.70 this week—the highest since the last week of February—after jumping the previous two weeks from 2.69 to 3.65. Bullish sentiment inched down to 60.0%, following a 10.2ppts surge the prior two weeks to 60.2%, holding around the 30-year high of 63.1% in late February. The correction count edged up to 23.8% after an 8.1ppts drop to 23.3%, which was the lowest reading since late February. Bearish sentiment slipped for the fourth week, by a total of only 2.6ppts, to 16.2%, just below the lower end of the narrow 16.5%-18.3% range shown most of this year. The AAII Ratio advanced for the second week last week to 58.6% after sliding the prior three weeks from 53.0% to 48.8%. Bullish sentiment fell to 34.5% after rebounding the prior week from 28.2% to 35.5%, while bearish sentiment fell for the third week from 29.9% to 24.3%.

S&P 500 Earnings, Revenues & Valuation (*link*): S&P 500 consensus forward revenues and forward earnings returned to record highs last week after both had edged down 0.1% from their week earlier record highs for the first time in five and 23 weeks, respectively. 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 edged up w/w to 5.3% from 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 17-week low of

10.8% 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 4.7% 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 18.0 from 17.9, which matches its 13-year high of 18.0 in early March and compares to a 15-month low of 14.9 in January 2016. The price-to-sales ratio was at a record high of 1.97. On an ex-Energy basis, valuation was steady at a 21-week high of 17.5, 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. But only Consumer Staples, Materials, and Telecom 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 an eight-month low now. The forward P/S ratio rose w/w for 6/11 sectors, and the P/E ratio rose w/w for 8/11 sectors (all but Health Care, Industrials, and Materials). Health Care had been surging recently; its P/E of 16.4 and P/S of 1.74 are stalling near their highest levels since August 2015, and 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 14.0, 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 28.3 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 20.0% in 2017 from 19.2% in 2016), Real Estate (17.2, 25.3), Financials (15.6, 14.3), Telecom (11.4, 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 (7.4, 7.2), Consumer Staples (6.6, 6.4), and Energy (3.9, 1.1).

S&P 500 Q2 Earnings Season Monitor (*link*): With over 65% 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 327 companies in the S&P 500 that have reported through noon yesterday, 71% exceeded industry analysts' earnings estimates, by an average of 5.8%; they averaged a y/y earnings gain of 12.9%. 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 1.3% above forecast and 5.7% 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 84% vs 79% a quarter ago. The widening gulf between the percentage of companies reporting higher y/y earnings growth and the percentage of 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

ADP Employment (*link*): According to ADP, "Job gains continued to be strong in the month of July. However, as the labor market tightens employers may find it more difficult to recruit qualified workers." Private industries added 178,000 to payrolls in July, following a big upward revision to June (to 191,000 from 158,000) and a smaller upward revision to May (233,000 from 230,000), for a net gain of 36,000. In July, service-providing industries (174,000) accounted for nearly all the gain; goods-producing jobs rose only 4,000, slowing from advances of 16,000 and 27,000 the prior two months. Within service-providing, the biggest increases came from administrative/support services (42,000), health care/social assistance (41,000), and trade, transportation & utilities (24,000). Within goods-producing, gains in natural resources (4,000) and construction (6,000) more than offset a decline in manufacturing (-4,000) payrolls, which fell for the first time this year. Medium-sized companies topped the leader board again last month, boosting payrolls by 83,000—with the mix 70,000 services and 13,000 goods-producing. Small businesses moved back up to the number two slot, adding 50,000 to payrolls—nearly double June's gain—all service-providing (52,000); goods-producing industries cut 3,000 jobs, narrowing from June's 8,000 reduction. Large companies dropped to the bottom spot, but not by much, increasing payrolls by 45,000, with service-providing industries adding 51,000 jobs and goods-producing cutting 6,000 positions.

GLOBAL ECONOMIC INDICATORS

Japan Consumer Confidence (*link*): Consumer confidence in July rose more than expected, climbing to a four-month high. The consumer confidence index climbed to 43.8 in July, nearing its cyclical high of 44.0 recorded in March. Three of the four components advanced last month: overall livelihood (42.5 from 41.5), income growth (to 41.9 from 41.4), and willingness to buy durable goods (43.1 from 42.6)—with all remaining on volatile uptrends. The employment component slipped to 47.6 after climbing the previous two months from 47.3 to 48.4—which was the highest reading since September 2013.

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