**MORNING BRIEFING**
**August 8, 2017**

## Resolving Conundrums

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

(1) Revenues are looking up. (2) Mid-single-digit growth rates for revenues. (3) Slicing and dicing with and without energy. (4) Employment data suggest stronger growth than wages and salaries. (5) Why isn't demand side of labor market paying more for workers, while the supply side isn't demanding more for wages? (6) Global competition keeping a lid on prices, which is keeping a lid on wages. (7) Median wages rising faster than average ones. (8) Real hourly pay at record high resolves one conundrum in the labor market.

**Strategy: S&P 500 Revenues Rising.** Joe reports that S&P 500 revenues data for Q2 are now available for 84% of the companies (*Fig. 1*). The blended revenues per share, using actuals and estimates, rose to an annualized $1,203.68 during the quarter, up 2.8% from Q1 and matching the Q4-2016 result. Joe and I compare this series to S&P 500 forward revenues, which is the time-weighted average of analysts' consensus expectations for the current year and next year. This series has been on a solid uptrend since mid-2016, and climbing into record-high territory consistently since October 2016 through late July, when it exceeded $1,250.

Both series had stalled from the second half of 2014 through the first half of 2016 as a result of the global recession in the energy sector caused by the freefall in oil prices from mid-2014 through early 2016. The S&P 500 stock price index fell to a low of 1829.08 on February 11 last year on fears of a widespread recession. However, oil prices firmed over the rest of the year, and so did global economic growth. The S&P 500 index is now up 35.4% since last year's low.

This is just the latest example of our simple observation that, historically speaking, fears of recession cause bull market corrections, with a resumption of the bull market when those fears evaporate if the economy continues to grow. Bear markets occur when those fears are realized as a result of an economic downturn. (See our *S&P 500 Bull & Bear Market Tables*.)

One obvious exception was the 1987 bear market, when the S&P 500 fell 33.5% between August 25 and December 4 yet a recession did not occur. The selloff was mostly attributed to financial factors, including the threat by a congressional committee to eliminate the deductibility of interest expense in corporate takeovers. Portfolio insurance exacerbated the selloff. Importantly, revenues continued to grow. We can't show that with S&P 500 revenues-per-share data because that data series doesn't start until 1992 (*Fig. 2*). However, the series does track closely with manufacturing and trade sales of goods, which confirms that revenues grew in 1987 and 1988 (*Fig. 3*).

From August 2014 through February 2016, however, business sales did drop 6.8%. Excluding sales of petroleum products, business sales edged down 0.2% over this same period. That pattern was repeated in aggregate S&P 500 revenues with and without the revenues of the S&P 500 Energy sector (*Fig. 4*). Here are a few observations on the latest data:

(1) *Totals.* S&P 500 revenues per share rose 5.7% y/y through Q2. On an aggregate basis, revenues

rose 4.5% over this same period, while business sales rose 5.2% y/y through May (*Fig. 5*).

(2) *Ex Energy.* S&P 500 aggregate revenues excluding Energy rose 3.7% y/y during Q2 (*Fig. 6*). Business sales excluding petroleum products rose 4.6% through May.

(3) *Leading indicators.* Not surprisingly, the Index of Leading Economic Indicators is a good leading indicator of S&P 500 revenues per share (*Fig. 7*). The former jumped 0.6% m/m during June to a record high, auguring well for revenues.

(4) *The dollar.* Of course, there is an inverse correlation between the y/y growth rate of S&P 500 revenues per share and the yearly percent change in the trade-weighted dollar (*Fig. 8*). The strong dollar, along with plummeting oil prices, weighed on revenues especially during 2015. The dollar is now down 1.5% y/y, which should help revenues a bit.

**US Consumer I: Aggregate Income Conundrum.** On Monday, Debbie and I observed that there has been a strange divergence since early 2016 between our Earned Income Proxy (EIP) for private wages and salaries in personal income and the series it is supposed to be tracking (*Fig. 9*). From January 2016 through June of this year, the former is up $364 billion, while the latter is up $263 billion. The former has been growing with remarkable consistency around 4.0% since 2011, reflecting relatively stable growth in private payroll employment and in wages (*Fig. 10*). The growth rate of private wages and salaries has tended to fluctuate around our proxy, but has been mostly below it since 2016. Over the past 12 months through June, wages and salaries is up only 2.5% y/y while EIP is up 4.6%.

When Debbie and I first started to calculate the EIP, a seasoned economics reporter at *The New York Times* called me and asked me to explain how I calculated it. He double-checked the validity of my procedure with his sources at the Bureau of Economic Analysis (BEA). They told him—then he told me—that this is actually the way the BEA comes up with the preliminary estimate of private wages and salaries that is included in the monthly personal income release that comes out a couple of weeks after the employment report.

So what gives? The EIP is based on the number of private-sector payroll jobs multiplied by the average number of hours worked multiplied by average hourly earnings of all workers in private industries. Consider the following additional conundrums:

(1) *Consumer spending*. The EIP's growth rate has been tracking the growth rate in retail sales excluding gasoline, both on a y/y basis, awfully well since 2010 through all of 2016 (*Fig. 11*). This year, they've started to diverge a bit with the former up 4.6% through June and the latter up 3.1%.

The growth rate in total personal consumption expenditures has also been fluctuating around the growth rate of our EIP (*Fig. 12*). PCE rose 3.8% y/y during June, closer to the growth rate of our EIP (4.6%) than the growth rate of private wages and salaries (2.5%).

(2) *Personal saving.* The official data show consumption has been growing faster than disposable income, resulting in falling personal saving (*Fig. 13*). Over the past 12 months through June, personal saving has totaled $572 billion, well below the $714 billion average of this series since January 2009. Prior to the financial crisis, the average from 1990-2008 was $357 billion, or roughly half as much as post-crisis. This suggests that rapidly rising home prices prior to the crisis depressed personal saving, as consumers figured they could always tap into their home equity if they needed more cash. They figured wrong and have been saving twice as much since the crisis.

If our EIP is more in tune with reality than is the wages and salaries component of personal income, then personal saving is higher than shown by the official data.

**US Consumer II: Hourly Wage Conundrum.** Our EIP is based on hourly wages using average hourly earnings for all private-sector workers. The data are available since March 2006. A longer time series, starting in January 1964, is available for production and nonsupervisory workers, who have tended to account for roughly 82% of all workers (*Fig. 14*). Both measures show that wage inflation (on a y/y basis) remains remarkably subdued around 2.5% (*Fig. 15*).

Like all markets, there is a supply side and a demand side to the labor market. There's no doubting that demand for workers is strong. Monthly employment gains have been robust in recent years. They remained so through the first seven months of this year, when payroll employment rose 184,300 per month on average. The number of job openings has been hovering just north of 5.5 million since mid-2015 (*Fig. 16*). That almost matches the number of jobless workers, suggesting that unemployment is mostly frictional, resulting from geographic and skills mismatches. In July, 35% of small business owners said they had job openings, the highest percentage since 2000.

So why aren't employers raising wages at a faster pace to fill their job openings? The simplest answer was offered by one small business owner who was asked that very same question on a nightly TV news program recently. He said that he can't afford to pay more because his overseas competitors have cheaper labor. In a competitive market environment, any employer can compete for workers by paying more for them, but they can't raise their product prices above the market price to cover the extra cost. If they do so, they will lose revenues at the very same time as their costs are going up. Most would rather settle for the status quo on wages and do the best they can with the workers they have or can attract at current wage rates.

But why aren't workers demanding higher wage rates if the supply side of the labor market is so tight? During May, a record 3.2 million workers quit their jobs, presumably for better jobs, yet that isn't showing up in faster average wage hikes. The logic may be a bit circular, but here it is: The slow rate of wage increases has been outpacing consumer price increases, which have been held down by the slow pace of wage increases. As a result, perhaps workers haven't been unsatisfied, on the whole, with the buying power of their slowly rising wages. As we observed on Monday, real average hourly earnings rose to a record high in June (*Fig. 17*).

Interestingly, the Atlanta Fed's data on median wage growth does show that job switchers for the most part have been getting bigger wage gains than job stayers since the start of the data during 1997 (*Fig. 18*). That's continued to be the story during the current expansion, with switchers' wages up 3.6% y/y through June, while stayers are lagging behind with a 2.9% increase. Yet, on average, wages are showing gains around 2.5% y/y.

The solution to the conundrum may be that average wage inflation for all workers in fact has rebounded from a low of 1.5% near the end of 2012 to 2.5% currently, outpacing consumer price inflation. So, from this perspective, there is no conundrum: Wage inflation has increased in response to tighter labor markets, and real wages are rising to new highs; wage inflation hasn't been remarkably subdued when considered relative to consumer price inflation. This leads me to think that productivity might actually be better than the official data suggest.

## CALENDARS

**US. Tues:** NFIB Small Business Optimism Index 103.2, Job Openings 5.6m. **Wed:** Productivity & Unit Labor Costs 0.8%/1.4%, Wholesale Trade Inventories 0.6%, MBA Mortgage Applications, EIA Petroleum Status Report, Evans. (Bloomberg estimates)

**Global. Tues:** Germany Trade Balance (euros) 23.0b, China Trade Balance $23.0b, China Foreign Direct Investment. **Wed:** China CPI & PPI 1.5%/5.6% y/y, Japan Machine Tool Orders. (DailyFX estimates)

## STRATEGY INDICATORS

**S&P 500/400/600 Forward Earnings** (*link*): LargeCap's forward earnings rose 0.6% w/w to a record high last week, registering its biggest gain in 16 weeks. MidCap's surged the most since September 2013, rising 1.2% w/w to a record high for a 25th straight week. However, SmallCap's edged down for a second week to 0.3% below its mid-July record. 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 improved to 9.7% y/y from 9.4% a week earlier, which compares to a 64-month high of 10.2% 13 weeks ago and a six-year low of -1.8% in October 2015; MidCap's surged to a 66-month high of 14.0% y/y from 13.0%, which compares to a six-year low of -1.3% in December 2015; and SmallCap's dropped to a nine-week low of 12.0% from 12.6%, which compares to a 39-month high of 13.0% in mid-July and a six-year low of 0.3% in December 2015. LargeCap and MidCap consensus growth rates expected for 2017 have been edging higher lately, leading to a slight decline in the 2018 growth rates. However, 2018 should improve if the corporate tax rate changes. Here are the latest consensus earnings growth rates: LargeCap 11.6% and 11.0%, MidCap 12.3% and 12.6%, and SmallCap 8.9% and 18.8%.

**S&P 500/400/600 Forward Valuation** (*link*): Forward P/E ratios mostly moved lower 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 for a third straight week at a 20-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 fell to 17.8 from 18.1, 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 was up from a three-year low of 15.0 in January 2016. SmallCap's was down to 18.9 from 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 (P/S) ratios since data became available in 2004, valuations last week were similarly elevated for the three indexes: LargeCap's P/S of 1.97 was at a new record high, while MidCap's 1.29 was close to its record high of 1.37 in late February. SmallCap's 1.00 was 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 mostly lower last week as analysts continued to make adjustments following Q2 earnings results. The Q3 consensus fell w/w for seven of the 11 S&P 500 sectors and rose for three. Real Estate rose 2.5% w/w, ahead of Tech (1.7%) and Telecom (0.3). Sectors with the biggest w/w decline in their Q2 forecast: Energy (-5.2), Materials (-3.2), Consumer Discretionary (-2.5), and Utilities (-2.4). The S&P 500's Q3-2017 EPS forecast fell 4 cents w/w to $33.37, and is down 1.3% from $33.82 at the end of Q2. That represents a forecasted pro forma earnings gain for Q3-2017 of 7.1% y/y, down from Q2's blended 12.0% 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 7.5% a week earlier, and down from 8.7% at the end of Q2. Since the end of Q2, Q3 estimates are lower for eight sectors and higher for two. Real Estate's Q3 forecast has risen 3.3%, Tech's is up 1.2%, and Telecom is unchanged. Energy's has tumbled 18.8% for the worst decline, followed by the Q3 forecasts for Consumer Discretionary (-3.6), Materials (-3.2), and Utilities (-2.6). The S&P 500's Q3-2017 forecasted earnings gain of 7.1% y/y would be its fifth straight gain after four declines. Nine 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 7.1%. That's because analysts expect Energy to report another large profit jump in Q3 relative to very low earnings a year ago. That's down from Q2-2017 when all 11 sectors rose y/y on a blended basis, the first time that has occurred since Q3-2011 when 10/10 sectors rose y/y. The latest forecasted Q3-2017 earnings growth rates vs their blended Q2-2017 growth rates: Energy (130.8% in Q3 vs a 527.7% in Q2), Tech (9.7% vs. 15.8%), Industrials (7.9, 7.7), S&P 500 (7.1, 12.0), Financials (6.0, 13.0), Health Care (4.4, 8.5), Consumer Staples (4.0, 4.3), Materials (3.4, 7.6), Real Estate (3.2, 4.4), Consumer Discretionary (1.2, 3.3), Utilities (-0.7, 5.8), and Telecom (-1.0, 4.8).

**S&P 500 Q2 Earnings Season Monitor** (*link*): With over 84% 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 421 companies in the S&P 500 that have reported through noon yesterday, 72% exceeded industry analysts' earnings estimates, by an average of 6.1%; they averaged a y/y earnings gain of 12.3%. 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 higher 6.7%, and earnings were up a lower 8.6% y/y. On the revenue side, 68% beat sales estimates so far, with results coming in 1.1% above forecast and 5.4% higher than a year earlier. At this point in the Q1 season, a lower 65% had exceeded forecasts, companies reported revenues a lower 0.6% above forecast, and sales rose a higher 8.5% y/y. Q2 earnings results are higher for 72% of companies vs 64% at the same point in Q1, but revenues are higher for 81% vs 77% 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 during Q3. That would follow double-digit percentage earnings growth during Q1 and Q2, which were the first double-digit quarters seen since Q3-2011.

## GLOBAL ECONOMIC INDICATORS

**Global Composite PMIs** (*link*): Global economic activity in July eased for the second month, though remains at a solid pace. The J.P. Morgan Global Composite Output Index (C-PMI) ticked down to 53.5 last month from 53.7 and 53.8 the prior two months, holding around January's cyclical high of 53.9. The M-PMI (to 52.7 from 52.6) edged up in July, while the NM-PMI (53.7 from 53.8) edged down, with both remaining near cyclical highs. Developed markets (54.4 from 54.9) were the steadying influence in July, while emerging markets (51.4 from 51.5) continued to struggle. Activity in the Eurozone (55.7 from 56.3) eased a bit last month, but is still undergoing one of its strongest growth spells over the past six months. Within the Eurozone, Ireland's C-PMI (57.0) showed the strongest growth, followed by Spain (56.7), Italy (56.2), France (55.6), and Germany (54.7). Growth in the US (54.6 from 53.9) and UK (54.1 from 53.8) accelerated slightly, while growth decelerated in Japan (51.8 from 52.9). In the emerging economies, C-PMIs for Russia (53.4), China (51.9), Brazil (49.4), and India (46.0) were all below the global average of 53.5, though only slightly for Russia, while India's showed contraction for the first time this year.

**Global Non-Manufacturing PMIs** (*link*): Service-sector growth in July continued to expand at a solid pace. The J.P. Morgan NM-PMI (to 53.7 from 53.8) eased slightly, not far from January's 17-month high of 53.9. By region, business activity posted solid expansions in the Eurozone (55.4), US (54.7), and UK

(53.8). Within the Eurozone, most of the large economies showed very strong growth: Ireland (58.3), Spain (57.6), Italy (56.3), and France (56.0), while Germany's (53.1) was the slowest in 10 months. Meanwhile, Asian economies continued to struggle. Rates of expansion continued to slow in China (51.5 from 51.6) and Japan (52.0 from 53.3), while India's (45.9 from 53.1) contracted for the first time in six months. Among other emerging economies, growth slowed sharply in Russia (52.6 from 55.5), while Brazil's (48.8 from 47.4) contracted for the third month.

**US Non-Manufacturing PMI** (*link*): The US service sector in July grew at its slowest pace in 11 months according to the ISM survey, while it expanded at its fastest pace in six months according to Markit's. ISM's NM-PMI sank from 57.4 in June to 53.9 in July, considerably below the first-half average of 56.9. All four components slowed last month: business activity (to 55.9 from 60.8), new orders (55.1 from 60.5), employment (53.6 from 55.8), and supplier deliveries (51.0 from 52.5). Markit's NM-PMI rose for the fourth month, from 52.8 in March to 54.7 in July—the highest since January. According to the report, the acceleration in business activity was supported by the fastest expansion in new orders in two years, which contributed to a stronger backlog of work. As a result, firms increased jobs at the quickest pace so far this year.

**Germany Manufacturing Orders** (*link*): June orders rose for the fourth time in five months, by 1.0% m/m and 4.5% over the period. June's advance was driven by a widespread rebound in domestic orders (5.1%), with capital (7.6), intermediate (2.9), and consumer (2.7) goods billings all in the black. Meanwhile, foreign orders—which drove May's growth—sank 2.0% after rebounding 3.4% in May. The decline in foreign orders reflected lower billings from both inside (-2.5) and outside (-1.5) the Eurozone. The drop in orders from within the Eurozone was entirely capital (-7.6) goods orders; both consumer (7.6) and intermediate (3.3) goods billing rose. Capital (-4.1) goods orders also led the decline in billings from outside the Eurozone, with consumer (-2.8) goods orders also in the red; intermediate goods orders (5.6) rose.

**Germany Industrial Production** (*link*): Industrial production unexpectedly fell in June for the first time this year. June's headline production, which includes construction, sank 1.1% after a five-month surge of 4.9% to a new record high. Manufacturing output contracted 1.4% after a five-month jump of 4.6%, also to a new record high. Consumer durable (-2.6%), capital (-1.9), intermediate (-1.2), and consumer nondurable (-0.2) goods production all took a step back after recent gains. Available July data, however, suggest June's blip in production was temporary. German business confidence soared to yet another record high in July, while Germany's M-PMI (58.1) remained in a strong expansionary phase at the start of the second half of 2017. Also, strong domestic demand pushed factory orders up 1.0% in June, a good sign for July production.

**Eurozone Retail Sales** (*link*): Eurozone retail sales in June continued to set new record highs. Sales rose in five of the first six months of 2017, up 0.5% m/m and 1.9% ytd. The increases during the first half of this year more than reversed the 0.4% decline during the final two months of last year. June's advance was widespread, driven by a 1.0% jump in automotive fuels, followed by gains of 0.7% in food, drinks, and tobacco, and 0.3% in nonfood products—excluding fuel. Data were available for three of the Big Four: Sales in Germany expanded for the fourth time in five months, up 1.1% in June and 3.2% over the period to a new record high, while Spain's rose for the fifth straight month by a total of 3.3% to a new cyclical high; meanwhile, French sales contracted 0.3% after a 0.5% gain in May. Germany was among the Eurozone economies recording the biggest gains in June, joined by Portugal (2.4%), Slovenia (1.7), and Estonia (1.1).

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