MORNING BRIEFING
August 17, 2017

Curbed & Unleashed Exuberance

See the collection of the individual charts linked below.

(1) On Target. (2) Shocking carnage. (3) Same old over-stored story. (4) The 800-pound gorilla. (5) Closing for good could be good for retailing. (6) Can Amazon continue to amaze? (7) Bubbles always start tiny. (8) SPACulators: Send us money so we can invest it for you as we see fit. (9) Crypto currencies are hot because they are issued in limited supplies by no shortage of crypto companies.

Retailing: Woes for Sale. Retail investors finally got a dose of good news yesterday. Target reported Q2 same-store sales that rose 1.3% y/y and upped its full-year EPS outlook to $4.34-$4.54, compared to the prior expectation of $3.80-$4.20. The shares rallied roughly 4% on the news.

That said, the rally barely dents the damage done this year to retail shares. Prior to Target's report, a number of retailers slashed earnings targets and reported drops in same-store sales. The carnage in some of the industry's leading stocks is truly shocking. Here are some of the worst performers ytd through Tuesday's close: J.C. Penney -55.7%, Dick's Sporting Goods (-49.4%), Advanced Auto Parts (-48.5), Macy's (-43.3), L Brands (-40.7), Kroger (-33.0), and Target (-24.8). I asked Jackie to go shopping for bargains. She came back with the following cautionary tale:

(1) *Two sources of grief*. The retail sales report released earlier this week unequivocally proves that retailers can't blame consumers, because consumers are spending what they earn and then some. Inflation-adjusted retail sales for the three months through July averaged 7.0% (saar) (*Fig. 1*). The problem comes down to two factors: over-expansion and Amazon.com. Occasionally, too much debt—often taken on to fund a leveraged buyout or stock buybacks—adds to the strain.

We discussed the glut in retail space just about a year ago (see our 8/18/16 *Morning Briefing*) and have been keeping a close eye on the amazing increase in Internet sales. It looks like the amount of goods sold by general merchandise stores has fallen so far that, if trends continue in the next year or two, the amount of goods sold by general retailers could be less than the amount of goods sold by Internet retailers (*Fig. 2*).

Ironically, strong Internet sales helped Target: Comparable digital channel sales grew 32% and contributed 1.1ppts to the overall company's same-store sales.

"Target has been launching exclusive brands and sprucing up its stores in an effort to keep customers from being wooed away by" Wal-Mart Stores and Amazon.com, a *WSJ* article explained yesterday. The company also plans to buy a logistics-software company and test a same-day delivery program in New York.

That said, while Target's total Q2 sales did improve 1.6% y/y, its costs jumped as well, so operating income before depreciation and amortization, interest expense, and taxes dropped by 6.9%. EPS increased 5.1% because the company's diluted share count dropped 6.0% y/y. Nonetheless, its shares jumped liked a coiled spring.

(2) *Closing for good.* So far, outside of Internet retailing and home improvement sales, analysts remain gloomy on the industry. Here are analysts' forecasts for the earnings growth of certain S&P 500 retail industries over the next 12 months: Department Stores (-4.2%), General Merchandise (1.1), Apparel Retail (6.6), Home Improvement (13.5), Specialty Stores (5.8), Automotive Retail (9.2), and Internet & Direct Marketing Retail (32.4) (*Fig. 3*, *Fig. 4*, and *Fig. 5*).

Some value investors are doing what they do best and scooping up shares that have been left in the sales bin. An 8/15 *WSJ* article reports that the Dodge & Cox Stock fund bought 5.4 million Target shares; Smead Value Fund also bought 220,000 shares of the general retailer. David Einhorn's Greenlight Capital boosted its Dillard's stake to 2.5 million shares in the quarter. And the T. Rowe Price Mid-Cap Value fund bought about 5.8 million shares of Kroger.

Earnings multiples in certain retail industries have compressed sharply over the past year. S&P 500 Home Furnishing Retail has a forward P/E of 7.3 compared to the 8.9 multiple it had a year ago; others with shrunken valuations include: Automotive Retail (14.4, 19.2), General Merchandise Stores (14.6, 16.5), and Apparel Retail (15.3, 19.0). Other P/E multiples in the industry have held their ground: Department Stores (10.3, 10.9), Apparel & Accessories (17.1, 17.2), and Home Improvement Retail (18.6, 19.4).

What could turn things around? Companies are shuttering stores at a pace that would normally imply a serious recession. Ytd, 5,630 store closures have been announced, up 175% y/y, according to retail analyst Deborah Weinswig, who expects the number will climb to 9,452 by yearend. If she's on target, store closures this year will top those closed in 2008 by 361%. When enough stores have been shuttered—and capacity is taken out of the system—same-store sales will start improving.

Another alternative: Amazon could stub its toe. The Internet giant is expanding—and spending—in many different directions. It's taking on its largest acquisition, the $13.4 billion purchase of Whole Foods. It's also facing angry tweets from the POTUS.

So far, Amazon's execution has been nearly flawless, witness the 60% jump in sales during the most recent Prime Day. But competing CEOs—and value investors—can always dream!

IPOs: Exuberant Offerings. There is lots of chatter about bubbles these days, and, unfortunately, they're not the tiny ones Don Ho crooned about. While much of the bubble talk has centered on high stock multiples or low bond yields, we'd suggest taking a look at the new issue market. There are two bubblicious areas of note, and of course they have acronyms: SPACs and ICOs.

"SPAC" stands for "Special Purpose Acquisition Corp.," which is sometimes referred to as a blank-check company. "ICOs" means "Initial Coin Offerings." Together, both offerings have raised billions of dollars this year from investors who may not know what their money is buying. I asked Jackie to speculate on these developments. Here is her take:

(1) *Blank checks.* SPACs raise money in the IPO market just like traditional companies. The difference is a SPAC doesn't have any operations. It has an investment management team who plan to use the proceeds from their IPO to purchase not-yet-identified businesses. Usually, those businesses are in an area of expertise for the managers.

Through the beginning of August, there have been 18 SPAC IPOs, which raised $5.5 billion, according to data from Renaissance Capital. That compares to 13 such IPOs raising $3.2 billion during all of last year and 20 deals raising $3.6 billion during 2015. The number of deals has been gradually increasing from the recession when none were priced in 2009 or 2010.

The previous peak in SPAC activity was in 2007, when 58 deals raising $10.7 billion hit the market. While the number of deals this year may not reach the prior heyday, the dollar amount raised could come close. This is concerning because ideally SPACs should raise and invest money when prices are low and they can make acquisitions on the cheap. However, when stock prices are low, investors aren't usually brave enough to buy into a blank-check offering. High stock prices appear to embolden bravery at what may turn out to be exactly the wrong time.

(2) *Minting money*. Initial coin offerings, ICOs, are done in the world of crypto currencies. They're often sold by organizations that have little more than a business plan, laid out in a white paper. Speculators are buying virtual coins, such as bitcoin, which typically don't have rights to any profits or ownership in the business. They are betting that the coins will rise in value because they are issued in limited supplies, which seems to be their only selling point. This is an odd bet on demand getting stimulated by a shortage of this funny money. It might be a good bet if the demand is bolstered by criminal activity, like hacking "Game of Thrones" episodes for ransom to be paid in the coin of the virtual realm. The coins, or "tokens," as they are sometimes called, can be traded on exchanges and held in a virtual wallet. No big bags of unmarked Benjamins are necessary to grease the criminal intents behind some of the demand for crypto currencies.

The SEC published on 7/25 an Investor Bulletin detailing the potential risks that investors face by participating in ICOs. The SEC also put issuers on notice that ICOs may be considered securities that are subject to federal securities laws. If they are securities, then they must be registered with the SEC.

If fraud does occur, the SEC warned that there may be limited recovery options because it's hard to follow the flow of money that's not being handled by banks. Issuers and exchanges can be overseas, and there's no central authority governing the offerings. It would be hard for the SEC or other agencies to freeze or secure the funds because they are being held in encrypted accounts and not by a third-party custodian.

But investors/speculators are undeterred by the risks. An 8/12 article in the *WSJ* estimated that $1.3 billion was raised in ICOs ytd. That doesn't include ongoing offerings (offerings can take place over a few weeks) or the additional 48 ICOs listed as coming to market between today and November 1, according to a listing on tokenmarket.net.

Deals are raising more than chump change. "Venture-backed startup Protocol Labs Inc. raised about $193 million for its Filecoin Network, according to the Filecoin website Saturday. The project, designed to create a marketplace for unused computer memory, raised about $187 million in the first hour Thursday and had earlier raised about $52 million from a group of venture capital investors," the *WSJ* article stated.

Given the structure of the market, success begets more success. Because an interested investor first has to exchange dollars into ether or bitcoin to purchase an ICO, these deals are creating demand for ether or bitcoin. Ether has risen 3,536% ytd, and bitcoin is up 337% (*Fig. 6*). At some point, if the number of ICOs falls, a major source of demand for these crypto currencies will be declining. ICOs could stall if too many dollars are required to buy an ether or if too many of these business-plan companies fail to germinate. This complicated area with its own language seems to be filled with exuberance, and that rarely ends well.

Of course, "a proliferation of new limited-supply coin offerings" is an oxymoron.

CALENDARS

US. Thurs: Jobless Claims 240k, Leading Indicators 0.3%, Headline & Manufacturing Industrial Production 0.3%/0.2%, Capacity Utilization 76.7%, E-Commerce Retail Sales, Weekly Consumer Comfort Index, Kaplan, Kashkari. **Fri:** Consumer Sentiment Index 94.0, Baker-Hughes Rig Count, Kaplan. (Bloomberg estimates)

Global. Thurs: Eurozone Headline & Core CPI 1.3%/1.2% y/y, Eurozone Trade Balance (euros) 20.3b, UK Retail Sales 0.1%m/m/1.2%y/y, Australia Employment Change & Unemployment Rate 20k/5.6%, ECB Account of Monetary Policy Meeting. **Fri:** Canada CPI 0.0%m/m/1.2%y/y. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): Our Bull/Bear Ratio (BBR) this week slipped back below 3.00. The BBR fell for the second week to 2.79 after climbing the prior three weeks from 2.69 to 3.70—which was the highest since the last week of February. Bullish sentiment sank for the third week by a total of 9.7ppts to 50.5%, with 7.0ppts of the drop occurring this week. Most of the bulls moved to the correction camp, with the count climbing 5.9ppts this week and 8.1ppts over the three-week period to 31.4%—back near its high for the year of 32.4% recorded in late March. Bearish sentiment ticked up 1.9ppt the past two weeks to 18.1%—holding in the narrow 16.5%-18.3% range shown most of this year. The AAII Ratio dipped for the second week last week from 58.6% to 51.0% over the period. Bullish sentiment fell from 36.1% to 33.7% last week, while bearish sentiment edged up from 32.1% to 32.3%.

S&P 500 Earnings, Revenues & Valuation (*link*): S&P 500 consensus forward earnings rose w/w to a new record high, but forward revenues edged down 0.1% from a record. The forward profit margin forecast edged up to a record high of 11.1%. 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 edged up to 10.9% from an 18-week low of 10.8%, but 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 4.8% is 0.5ppt lower and STEG of 9.3% is 1.6ppts lower. However, the S&P 500 ex-Energy forward profit margin was at a record high of 11.7%, which is its first since August 2007. Due to the w/w improvement in earnings, valuation fell to 17.7 from 17.8 a week earlier, which is down from late July's 13-year high of 18.0 and compares to a 15-month low of 14.9 in January 2016. The price-to-sales ratio was steady at 1.96, slightly below late July's record high of 1.97. On an ex-Energy basis, valuation was steady at 17.4, down from late July's 21-week high of 17.5, and compares to a 13-year high of 17.6 in early March.

S&P 500 Sectors Earnings, Revenues & Valuation (*link*):Consensus forward revenue forecasts rose last week for 3/11 sectors, and forward earnings rose for 4/11. Consumer Staples and Tech 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 dropped to a 10-month low, but its forward earnings edged up from an eight-month low. The forward P/S ratio rose w/w for 5/11 sectors, and the P/E ratio rose w/w for 4/11 sectors. These four sectors saw both measures rise w/w: Consumer Staples, Health Care, Industrials, and Utilities. Health

Care had been surging recently; its P/E of 16.2 and P/S of 1.72 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 13.9, but remains below 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 1.31 compares to a record high of 1.56 in May 2016, and its P/E of 27.1 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. Consumer Discretionary and Real Estate had their forecasted 2017 margin improve 0.1ppt w/w, but Financials and Materials both edged down 0.1ppt. Here's how the 11 sectors rank based on their current 2017 forecasts: Information Technology (to 20.1% in 2017 from 19.2% in 2016), Real Estate (18.6, 25.3), Financials (15.6, 14.3), Telecom (11.4, 11.2), Utilities (11.0, 11.4), S&P 500 (10.6, 10.1), Health Care (10.5, 10.3), Materials (9.7, 9.4), Industrials (9.2, 8.9), Consumer Discretionary (7.3, 7.2), Consumer Staples (6.5, 6.4), and Energy (3.9, 1.1).

US ECONOMIC INDICATORS

Housing Starts & Building Permits (*link*): Homebuilders in July continued to be hindered by shortages of skilled labor and lots, along with rising materials' costs. Starts fell for the fourth time in five months by 4.8% m/m and 10.3% over the period to 1.155mu (saar). Most of the weakness has been in multi-family starts, which dropped 15.3% and 27.3% over the comparable periods to a 10-month low of 299,000 units (saar). Single-family starts were down 0.5% and 2.4% over the same periods to 856,000 units (saar), though are still up 5.9% ytd, while multi-family starts are down 35.0%. Building permits slumped 4.1% last month to 1.223mu (saar), with single-family permits flat at 811,000 units and multi-family 11.2% lower at 412,000. On a more positive note, homebuilders' confidence bounced back in August, jumping 4 points to a three-month high of 68. All three HMI sub-indices rebounded this month, with current sales conditions up four points at 74, sales expectations for the next six months increasing five points to 78, and buyer traffic edging up a point to 49.

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