MORNING BRIEFING
August 21, 2017

Eclipse

See the collection of the individual charts linked below.

(1) Look up in the sky! It's a total eclipse of the sun! (2) P/Es aren't totally eclipsing Es. (3) Fed officials talking more about financial stability. (4) Yellen's swan song? (5) Fed more worried about bubble in bonds than in stocks. (6) Fed officials ponder why Phillips Curve Model isn't working. (7) Q2 earnings at record high. (8) Q2 profit margin at record high, refusing to revert to its mean. (9) Valuation measures back to record highs. (10) Movie review: "Wind River" (+ +).

The Fed I: Lurking in the Shadows. Don't look up at the eclipse today while you are driving. That's just common sense. Get out of stocks when they are overvalued, especially when P/E multiples eclipse earnings. That's common sense too, but it makes more sense if stocks are overvalued and a recession is lurking over the horizon. Stocks may be overvalued, but it's hard to discern a recession in the foreseeable future. It isn't hard seeing earnings continue to rise in record territory. So any sell-off is more likely to be yet another panic-attack correction rather than the beginning of a bear market.

The S&P 500 dropped sharply, by 1.5%, on Thursday last week. The financial press blamed the latest brouhaha in the White House for the selloff. Melissa and I think it had more to do with the July 25-26 FOMC minutes released on Wednesday. Fed officials are suddenly focusing on "financial stability."

The phrase appeared just four times in the minutes of the June 13-14 FOMC meeting. It appeared eight times in the latest minutes, with a lengthier discussion of this topic than in the recent past. Perhaps Fed officials are all getting excited about going to their annual conclave at Jackson Hole this week, from Thursday through Saturday. The topic this year is "Fostering a Dynamic Global Economy." Fed Chair Janet Yellen, who might be singing her swan song, is scheduled to speak on Friday and focus on, you guessed it, financial stability.

During their meeting in late July, the FOMC participants did something they rarely do—they "considered equity valuations in their discussion of financial stability." Such attention by the Fed should make stock investors nervous. However, the discussion must have been fairly brief and benign. This was the gist of what was said on this subject per the minutes:

(1) "According to another view, recent rises in equity prices might be part of a broad-based adjustment of asset prices to changes in longer-term financial conditions, importantly including a lower neutral real interest rate, and, therefore, the recent equity price increases might not provide much additional impetus to aggregate spending on goods and services."

(2) "A couple of participants noted that favorable macroeconomic factors provided backing for current equity valuations; in addition, as recent equity price increases did not seem to stem importantly from greater use of leverage by investors, these increases might not pose appreciable risks to financial stability."

That's not very threatening to the bull market. There was more concern expressed about a potential jump in bond yields: "A number of participants pointed to potential concerns about low longer term interest rates, including the possibility that inflation expectations were too low, that yields could rise abruptly, or that low yields were inducing investors to take on excessive risk in a search for higher returns."

It sure doesn't sound like the Fed is about to tighten monetary policy for the sake of restoring financial stability in the stock market, i.e., to push valuations lower. Quite the opposite, the minutes suggested that Fed officials remain puzzled by how low inflation remains, presumably giving some of them second thoughts about raising interest rates again anytime soon.

The Fed II: In the Dark. At the latest FOMC meeting, there was also a discussion about the Phillips Curve Model, on which policymakers rely heavily to predict inflation: "A number of participants noted that much of the analysis of inflation used in policymaking rested on a framework in which, for a given rate of expected inflation, the degree of upward pressures on prices and wages rose as aggregate demand for goods and services and employment of resources increased above long-run sustainable levels." However, the model isn't working, as noted in the minutes: "A few participants cited evidence suggesting that this framework was not particularly useful in forecasting inflation."

Yet just because it isn't working doesn't mean they won't continue to believe in it: "However, most participants thought that the framework remained valid, notwithstanding the recent absence of a pickup in inflation in the face of a tightening labor market and real GDP growth in excess of their estimates of its potential rate." How does a model that isn't working remain valid? Easy, just come up with excuses for it to explain its temporary shortcomings. The following were ticked off in a short list of possible reasons:

(1) "a diminished responsiveness of prices to resource pressures"

(2) "a lower natural rate of unemployment"

(3) "the possibility that slack may be better measured by labor market indicators other than unemployment"

(4) "lags in the reaction of nominal wage growth and inflation to labor market tightening and restraints on pricing power from global developments and from innovations to business models spurred by advances in technology"

Additionally, "[a] couple of participants argued that the response of inflation to resource utilization could become stronger if output and employment appreciably overshot their full employment levels, although other participants pointed out that this hypothesized nonlinear response had little empirical support."

Debbie and I pick Door #4. Intense global competition, proliferating technological innovations, and aging populations all are fundamentally disinflationary. Of course, this explanation for the failure of the Phillips Curve Model isn't a temporary shortcoming but rather a total breakdown, suggesting that it is time to deep-six it.

Earnings: The Shining. Meanwhile, on the bright side, the earnings recession is over. S&P 500 operating earnings per share were eclipsed by the energy recession from Q4-2014 through Q2-2016, when the Thomson Reuters (TR) measure was flat to down on a y/y basis (*Fig. 1*). Growth resumed during the second half of 2016 and first half of 2017.

Joe has updated all of our chart publications with Q2 earnings data. He reports that the TR measure of earnings rose 10.1% y/y during Q2-2017 to a new record high, while revenues rose 5.7% y/y (*Fig. 2* and *Fig. 3*).

That put the S&P 500 operating profit margin (based on TR data) at a record high of 10.8% (*Fig. 4*). "Ouch" is the sound you just heard from all those reversion-to-the-mean bears, who can go back to sleep. The 52-week forward outlook looks outstanding:

(1) *S&P 500 forward revenues per share*, which tends to be a weekly coincident indicator of actual earnings, continued its linear ascent into record-high territory through the week of August 10 (*Fig. 5*).

(2) *S&P 500 forward operating earnings per share*, which works well as a 52-week leading indicator of four-quarter trailing operating earnings, has gone vertical since March 2016 (*Fig. 6*). It works great during economic expansions, but terribly during recessions. If there is no recession in sight, then the prediction of this indicator is that four-quarter-trailing earnings is heading from $126 currently (through Q2) to $140 over the next four quarters.

Some sectors shone more brightly than others during Q2. Here is the y/y performance derby for the S&P 500 revenues growth (*Fig. 7*): Energy (14.3%), Tech (9.7), Industrials (7.8), S&P 500 (5.7), Utilities (5.3), Consumer Staples (4.8), Financials ex-Real Estate (4.4), Consumer Discretionary (3.5), Health Care (2.4), Real Estate (0.8), Materials (-1.4), and Telecom (-3.9).

Here is the same for earnings growth (*Fig. 8*): Energy (returned to a profit), Telecom (45.8%), Tech (34.3), S&P 500 (19.6), Utilities (14.2), Financials ex-Real Estate (13.0), Industrials (12.5), Health Care (8.6), Consumer Staples (6.7), Consumer Discretionary (1.9), Materials (-0.4), and Real Estate (-14.6).

Valuation: Too Close to the Sun. Now that we have S&P 500 revenues for Q2, we can calculate the ratio of the S&P 500 market capitalization to it, yielding a valuation measure that is very similar to the Buffett Ratio—which is the ratio of the market cap of all equities traded in the US except foreign issues to nominal GNP (*Fig. 9*). The former remains unchanged at 2.00 during Q2, matching the previous record high during Q4-1999. The weekly version of this price-to-sales ratio rose to 1.96 during the week of August 10 (*Fig. 10*). Valuation is certainly very close to the sun. However, it isn't totally eclipsing earnings.

Movie. "Wind River (+ +) (*link*) is a murder mystery set in an Indian reservation in Wyoming. It's well written. It is also well paced, taking the time to develop the lead character, who is well played by Jeremy Renner. It was filmed during the winter, and clearly demonstrates why Fed officials schedule their annual meeting in Jackson Hole, Wyoming late in August.

CALENDARS

US. Mon: Chicago Fed National Activity Index 0.22. **Tues:** Richmond Fed Manufacturing Index 11, FHFA Price Index 0.5%. (Bloomberg estimates)

Global. Mon: Japan All Industry Activity Index 0.4%. **Tues:** Eurozone ZEW Economic Sentiment Index, Germany ZEW Economic Sentiment Index 15, Canada Retail Sales 0.3%. (DailyFX estimates)

STRATEGY INDICATORS

Global Stock Markets Performance (*link*): The US MSCI index fell 0.6% last week as it ranked 40th of the 49 markets and 30 countries rose in US dollar terms—compared to 24th a week earlier, when it fell 1.5% as seven countries moved higher. The AC World ex-US index outperformed the US MSCI for the fifth time in six weeks, rising 0.4% compared to a 1.6% drubbing a week earlier, which was its worst decline in 40 weeks. Last week saw most regions rise w/w, but BRIC performed best with a gain of 1.9%, followed by EM Asia (1.7%), EM Latin America (1.5), and EMU (0.8). EMEA was the week's worst-performing region, edging down 0.1% and followed by EAFE (0.0) and EM Eastern Europe (0.1). Argentina (7.9) was the best-performing country, followed by South Africa (3.3), Peru (3.1), New Zealand (3.0), and Korea (2.6). Pakistan was the worst performer as it fell 4.4%, followed by Egypt (-3.4), Denmark (-1.7), and Jordan (-1.5). The US MSCI is up 8.4% ytd, with its ranking down one place w/w to 39th of the 49 markets, and continues to trail the AC World ex-US (15.2) on a ytd basis. Forty-five of the 49 markets are positive ytd, now led by Argentina (43.0), Austria (38.8), Poland (38.2), Turkey (36.9), China (34.5), Greece (29.9), and Hungary (29.8). The worst country performers ytd: Pakistan (-19.2), Russia (-13.0), Israel (-6.3), and Jordan (-1.8). EM Asia is the best-performing region ytd with a gain of 26.8%, ahead of BRIC (25.2), EM Latin America (19.5), and EMU (19.1). The worst-performing regions: EM Eastern Europe (-0.2), EMEA (4.7), and EAFE (13.8).

S&P 1500/500/400/600 Performance (*link*): All three indexes fell last week, but at a slower pace than a week earlier. LargeCap (-0.6%) outperformed for a fourth week and fell less than MidCap (-1.1) and SmallCap (-1.5). At the week's end, LargeCap stood 2.2% below its August 7 record high, MidCap was 5.6% below its July 25 high, and SmallCap was 6.6% below its July 25 peak. Four of the 33 sectors rose w/w, up from just one rising a week earlier, which was the lowest since September 2016. Last week's gainers: LargeCap Utilities (1.3%), LargeCap Materials (0.4), LargeCap Real Estate (0.2), and MidCap Utilities (0.1). Last week's worst performers: SmallCap Energy (-4.3), MidCap Energy (-3.8), SmallCap Consumer Discretionary (-3.3), SmallCap Telecom (-3.1), and MidCap Telecom (-3.1). Eighteen of the 33 sectors are positive ytd, with LargeCap (8.3) easily beating both MidCap (1.9) and SmallCap (-2.3). Tech and Health Care dominate the biggest sector gainers ytd: LargeCap Tech (21.3), SmallCap Health Care (15.7), MidCap Health Care (15.0), SmallCap Utilities (14.1), LargeCap Health Care (13.0), LargeCap Utilities (11.6), and MidCap Tech (11.0). Energy and Telecom dominate the worst performers ytd: SmallCap Energy (-44.8), MidCap Energy (-37.2), MidCap Telecom (-36.4), LargeCap Energy (-17.6), and LargeCap Telecom (-11.7).

S&P 500 Sectors and Industries Performance (*link*): Just three of the 11 sectors rose last week, and six outperformed the S&P 500's 0.6% decline. This compares to one sector rising a week earlier, when six outperformed the S&P 500's 1.4% decline. Utilities was the best-performing sector as its 1.3% gain beat these outperforming sectors: Materials (0.4%), Real Estate (0.2), Consumer Staples (0.0), Tech (0.0), and Financials (-0.5). Energy (-2.7) was the worst-performing sector for a third straight week, followed by Telecom (-1.8), Consumer Discretionary (-1.8), Industrials (-1.1), and Health Care (-0.8). So far in 2017, nine of the 11 sectors are higher, but only three have outperformed the S&P 500's 8.3% gain. The best performers in 2017 to date: Tech (21.3), Health Care (13.0), and Utilities (11.6). The eight sectors underperforming the S&P 500 ytd: Energy (-17.6), Telecom (-11.7), Real Estate (3.8), Financials (5.5), Industrials (6.4), Consumer Staples (6.6), Materials (7.7), and Consumer Discretionary (8.3).

Commodities Performance (*link*): Eight of the 24 commodities we follow rose last week as the S&P GSCI commodities index fell 0.6%, down from 12 commodities rising a week earlier, when the GSCI index fell 0.4%. Industrial metals-related commodities were among the week's strongest performers: Zinc (8.0%), Nickel (3.0), Sugar (1.6), Lead (1.5), and Copper (1.1). Last week's laggards: Coffee (-8.4), Kansas Wheat (-5.8), Wheat (-5.2), Cocoa (-5.0), and Lean Hogs (-3.6). Industrial metals-related commodities also dominate the best performers in 2017 so far: Aluminum (21.7), Zinc (21.7), Lead (17.3), Copper (17.1), and Gold (12.1). This year's laggards: Sugar (-31.3), Natural Gas (-21.3), Cocoa (-11.7), Crude Oil (-9.4), and Live Cattle (-8.7).

Assets Sorted by Spread w/ 200-dmas (*link*): Spreads between prices and 200-day moving averages (200-dmas) rose last week for 8/24 commodities, 6/9 global stock indexes, and 2/33 US stock indexes compared to 11/24, 1/9, and 0/33 rising a week earlier, respectively. Ten commodities trade above their 200-dmas, down from 14 a week earlier as these four turned negative w/w: Coffee, Corn, Kansas Wheat, and Wheat. Commodities' average spread fell w/w to -0.7% from 0.4%. Zinc now leads all commodities and all assets at 15.2% above its 200-dma, and performed the best of all commodities and all assets last week as it improved 7.9ppts. Sugar (-21.7%) trades the lowest of all commodities, but Coffee (-5.7) tumbled 8.1ppts last week for the worst performance of all commodities and all assets. The global indexes trade at an average of 4.4% above their 200-dmas, up from 3.6% above in the prior week. Eight of the nine global indexes trade above their 200-dmas, unchanged from a week earlier. Chile (10.8) leads the global indexes, but Indonesia had the best performance among its peers as it gained 2.1ppts to 6.6%. Canada (-2.8) trades the lowest of the global assets relative to their 200-dmas, but Japan (0.5) performed the worst of its country peers last week, falling 1.7ppts. The US indexes trade at an average of 2.3% below their 200-dmas, with 14 of the 33 sectors above, down from a -1.3% average a week earlier, when 19 sectors were above. These five US indexes turned negative w/w: MidCap Consumer Discretionary, MidCap Industrials, SmallCap Real Estate, SmallCap Tech, and SmallCap Telecom. SmallCap Utilities leads all US stock indexes at 9.7% above its 200-dma, followed by LargeCap Tech (8.9). LargeCap Utilities (6.9) rose 1.0ppt w/w for the biggest increase among the US stock indexes. SmallCap Energy trades 32.4% below its 200-dma, the lowest among the US stock indexes and all assets. SmallCap Consumer Discretionary (-3.8) had the worst performance of the US stock indexes last week, falling 3.5ppts w/w.

S&P 500 Technical Indicators (*link*): The S&P 500 index remained in a Golden Cross last week for a 69th week (after 17 weeks in a Death Cross) despite the deterioration in its short-term technicals. The index's 50-day moving average (50-dma) relative to its 200-dma weakened for a third straight week and the seventh time in eight weeks, falling to a 30-week low of 4.1% above its 200-dma from 4.3%. That's down from a 34-month high of 5.4% in early April and compares to a six-month low of 2.0% in early December and a 52-month low of -4.5% in March 2016. Furthermore, the 50-dma and 200-dma diverged and failed to rise together for the first time in 36 weeks. The S&P 500's 50-dma moved lower for the first time in 39 weeks as the index closed below its 50-dma for a second straight week for the first time since late April and only the second time since the November election. The S&P 500 weakened to a four-month low of 1.0% below its falling 50-dma from 0.3% below its rising 50-dma a week earlier. These 50-dma readings compare to a 38-week high of 4.8% on December 13, and a 52-month high of 6.2% in March 2016. The S&P 500 fell to a post-election low of 3.0% above its rising 200-dma from 4.0% a week earlier, and is down from an 11-week high of 7.4% in early June. That's down from a 38-month high of 9.4% on March 1, but up from an eight-month low of -0.1% immediately before the election.

S&P 500 Sectors Technical Indicators (*link*): Four of the 11 sectors improved w/w relative to their 50-dma (Consumer Staples, Materials, Real Estate, and Utilities), and two improved relative to their 200-dmas (Materials and Utilities). Three of the 11 sectors trade above their 50-day moving averages (50-dmas), down from four a week earlier as Financials fell below in the latest week. Tech, Telecom, and Utilities are the only sectors trading above their 50-dmas, matching mid-April's reading, which was the lowest since the election. All 11 sectors had been above their 50-dmas during mid-January, and all 11 were below the week before the election, for the first time since December 11, 2015. Energy has traded below its 50-dma in 29 of the past 30 weeks, and Consumer Staples was below for a ninth week. The longer-term picture is better: Nine of the 11 sectors were above their 200-dmas last week, unchanged from a week earlier, as Energy was below for a 24th week and Telecom for a 22nd week. Nine sectors are in a Golden Cross, with 50-dmas higher than their 200-dmas, unchanged from a week earlier and leaving Energy and Telecom still out of the club. All 11 had been in a Golden Cross during a 21-week streak that ended October 24, the longest such stretch since October 2014. Four of the 11 sectors have rising 50-dmas, up from two a week earlier, as Tech and Utilities turned up w/w and joined Financials and Health Care. Consumer Staples' 50-dma has fallen in five of the past six weeks, and Energy's fell for a 27th week. Ten sectors have rising 200-dmas, unchanged from a week earlier, as Energy's fell for a 17th week.

US ECONOMIC INDICATORS

Leading Indicators (*link*): "The U.S. LEI improved in July, suggesting the U.S. economy may experience further improvements in economic activity in the second half of the year," according to the Conference Board. The Leading Indicators Index (LEI) advanced for the 11th straight month, by 0.3% in July and 4.0% over the period, to another new record high. July's advance once again was broad-based, with eight of the 10 components in the plus column. Building permits (-0.12ppt), the largest positive contributor in June, was the only negative one in July; the average workweek was unchanged. The biggest positive contributions came from the interest rate spread (0.13), new orders diffusion index (0.10), leading credit index (0.09), and consumer expectations (0.09). The remaining indicators—stock prices, jobless claims, real nondefense capital goods orders, and real consumer goods orders—contributed from 0.01 to 0.03ppt.

Coincident Indicators (*link*): The Coincident Indicators Index (CEI) in July also advanced to yet another new record high. The CEI has posted only one decline in 16 months, increasing 0.3% m/m and 2.8% over the time span. All four components contributed positively last month: 1) Nonfarm payroll employment continues to head straight up to new record highs; it hasn't posted a decline since July 2010. 2) Real personal income—excluding transfer payments—remains on its upswing since stalling in early 2016 at record highs; it's up 2.3% since declining by 0.4% the first two months of 2016—to a new record high. 3) Real manufacturing & trade sales rebounded 0.8% in the three months through July, climbing back to within 0.2% of its record high posted at the end of last year. 4) Industrial production rose for the sixth straight month, by 0.5% in July and 2.1% over the period to its highest level since January 2015.

Industrial Production (*link*): Manufacturing output fell in July for the second time in three months as motor vehicle production contracted for the fifth time this year. Motor vehicle output dropped 3.6% in July and 6.7% the past three months, depressing manufacturing output, which fell 0.1% last month after a 0.2% uptick in June and a 0.6% loss in May. However, factory output excluding autos expanded for the third time in four months in July, by 0.2%m/m and 1.0% over the period, to the highest reading since August 2008. Meanwhile, headline industrial production advanced for the fifth time in six months, climbing 0.2% last month and 2.3% over the six-month time span to a new cyclical high, as mining output continued to recover, rising 0.5% in July and 10.7% since bottoming just 10 months ago. Utilities output climbed for the fourth time in five months by 1.6% in July and 11.6% over the period.

Capacity Utilization (*link*): The headline capacity utilization rate in July held at June's 22-month high of 79.7%, still 3.2ppts below its long-run (1972-2016) average. Manufacturing's capacity utilization rate edged down from 75.5% to 75.4%, 3.0ppts below its long-run average. The capacity utilization rate for mining continued to climb, reaching to a 28-month high of 84.6% last month, while the utilities rate rose to a seven-month high of 78.1%; the rates for both industries remained considerably below their long-run averages.

Regional M-PMI (*link*): Two Fed districts so far have reported on manufacturing activity for this month—New York and Philadelphia—and they show growth in the sector improved after slowing in July. We average the composite, orders, and employment measures as data become available. The composite index rebounded to 22.1, almost reversing July's decline from 23.7 to 14.7; it was at 31.0 in February—which was the highest reading since July 2004. The New York (to 25.2 from 9.8) measure accelerated sharply this month, recording its best growth in orders since September 2014, while Philadelphia's (18.9 from 19.5) continued to expand at a robust pace. The new orders gauge expanded markedly from 7.7 in July to 20.5 this month as billings in both the New York (20.6 from 13.3) and Philadelphia (20.4 from 2.1) districts accelerated sharply—with the former's back near March's cyclical peak of 21.3. The employment measure was little changed at 8.2 this month, after slowing steadily from April's cyclical high of 16.9 to 7.4 last month. Philadelphia (10.1 from 10.9) manufacturers continued to expand payrolls at a solid pace, while New York's (6.2 from 3.9) added to payrolls at a slightly faster pace this month, after slowing to a five-month low in July.

Consumer Sentiment (*link*): Consumers so far this month were almost as optimistic about the economy as they were at the start of the year, when President Trump took office, according to the mid-month reading. Richard Curtin—chief economist of the University of Michigan consumer survey—noted, "Too few interviews were conducted following Charlottesville to assess how much it will weaken consumers' economic assessments." The Consumer Sentiment Index (CSI) rebounded from 93.4 to 97.6 in mid-August, within striking distance of January's cyclical high of 98.5. The rebound in the CSI was driven entirely by an 8.5-point jump in the expectations component to a seven-month high of 89.0, with consumers upbeat about their financial prospects in the year ahead. Meanwhile, the present situation component slipped to 111.0 in mid-August after climbing to a new cyclical high of 113.4 in July. Mr. Curtin cautions, "The Charlottesville aftermath is more likely to weaken the economic expectations of Republicans, since prospects for Trump's economic policy agenda have diminished." Republicans have been the most optimistic in 2017, according to the report.

GLOBAL ECONOMIC INDICATORS

Eurozone CPI (*link*): July's CPI rate was 1.3% y/y—matching both its flash estimate and June's reading—holding below the ECB's goal of just under 2.0% for the third month; 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) had the highest annual rate, accelerating from June but considerably below the recent peak of 9.3% during February; the rate for non-energy industrial goods (0.5 from 0.4) accelerated slightly for the second month. The rates for both services and food, alcohol & tobacco were unchanged at 1.6% and 1.4%, respectively. The core rate—which excludes energy, food, alcohol, and tobacco—rose for the second month from 0.9% in May to 1.2% last month—back at April's 1.2%, which was the highest rate in almost four years. Of the top four Eurozone economies, inflation rates in Spain (1.7% y/y) and Germany (1.5) were above the Eurozone's 1.3%, while Italy's (1.2) and France's (0.8) were below. Ireland (-0.2) and Cyprus (-0.1) were the only Eurozone economies with negative rates.

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