MORNING BRIEFING
August 22, 2017

Après L'Eclipse

See the collection of the individual charts linked below.

(1) Hemingway on life's delusions: "Isn't it pretty to think so?" (2) The hard-nosed bull says: "Ignore the bearish omens." (3) The Hindenburg Omen is back. Is it bullish or bearish when it coincides with a total solar eclipse? (4) Chart watchers looking for trouble. (5) Eclipses come and go, while the sun always remains hot and bright. (6) S&P 500/400/600 forward earnings suggests Q3 earnings season will be upbeat. (7) Earnings hooks sighted during Q2. (8) Menu options for 2018 earnings depend on tax rate.

Strategy: The Sun Also Rises. *The Sun Also Rises* is a novel written by Ernest Hemingway in 1926 about a group of American and British expats who travel from Paris to the Festival of San Fermín in Pamplona, Spain to watch the running of the bulls and the bullfights. The bulls have certainly had a great run in the stock market since March 9, 2009. The S&P 500 is up 258.9% since then. It's up 32.8% from last year's low on February 11. It's up 8.5% ytd.

The latest record high was made on August 7, with the S&P 500 down just 2.1% since then. Yet every time that the bull stops charging ahead, the bears start growling that a major correction is imminent, which could turn into a serious bear market. Many of them are particularly good at finding bearish omens in the market's technical indicators.

Yesterday, everyone in America was watching the running of the solar eclipse from the West Coast to the East Coast. Despite all the excitement, or maybe because of it, the stock market shrugged it all off. Perhaps that's because there is no folklore about the usefulness of eclipses as omens of the future.

When all else fails, there is always the "Hindenburg Omen." On Friday, Associated Press reported that it has been sighted. The market has the potential to crash when both the number of securities that form new 52-week highs and the number of securities that form new 52-week lows are greater than 2.2% of the total number of issues that trade on the NYSE (for that specific day).

Also on last Friday, The Street reported that 177 stocks hit new 12-month highs, while 226 fell to new 12-month lows. It warned that this "terrifying stock market indicator" means that investors should "stay vigilant and be ready to move as the price action continues." The omen supposedly works best after flashing a few times. Omen watchers say there has been a rash of them in recent days. One of these spotters has counted 74 of them so far in 2017, second only to 78 recorded in November 2007.

You have been warned. However, it's obvious that the running of the bulls since March 9, 2009 has run over lots of bearishly inclined market technicians. Consider the following:

(1) *Moving-average watchers* have seen plenty of (obviously bearish) "Death Crosses"—when the 50-day moving average of the S&P 500 fell below the 200-day moving average—along the way, just before they were killed by the latest stampede to higher ground (*Fig. 1*). The 200-day moving average of the S&P 500 continues to rise, with the 50-dma stumbling a bit recently but remaining above the 200-dma (*Fig. 2*).

(2) *Market-cap watchers* regularly manage to find ominous divergences in their charts. They compare the equal-weighted S&P 500 to the market-cap weighted version of the index (*Fig. 3* and *Fig. 4*). They've warned that the ratio of the two has been declining all year, showing that large-cap stocks are outperforming smaller-cap ones. They gave us a similar warning during 2015 just before the market's latest advance started early last year.

(3) *Breadth watchers* tend to get especially alarmed when an advancing stock market is led by fewer and fewer stocks. It's happening again now. At the end of last week, 65.6% of the S&P 500 stock price components were up on a y/y basis, down from a recent peak of 89.8% on February 10 at the start of the year (*Fig. 5*). Not surprisingly, this measure is highly correlated with the percentage of S&P 500 companies trading above their 200-day moving averages (*Fig. 6*). This indicator fell sharply recently to 59.6% on Friday, down from 64.6% the previous week.

Strategy II: The Sun Will Come Out Tomorrow. Eclipses come and go. Yet the sun is always shining even at night, on the other side of our planet. We take the sun for granted except for on days like yesterday when it played peekaboo with the moon. The sun is pretty amazing. It's a star that is almost three-quarters hydrogen, with the rest mostly helium. Lucky for us Earthlings, it is brighter than 85% of the stars in the Milky Way. It's hot up there, with the sun's core around 15 million Celsius. It's a bit cooler in the photosphere (5,500 degrees C) and the chromosphere (4,320 degrees C). The latter could be seen as a red rim around the sun during yesterday's eclipse. The sun's light and heat take about eight minutes to reach us.

Fortunately, Joe and I don't need to comment on the cosmic meaning of life. Currently, we are doing our best not to get blinded by dark technical sightings that some seers have observed. We continue to focus on the fundamentals, which remain bullish. As we noted on Monday, the Q2 earnings season was a good one:

(1) *Forward earnings.* Auguring well for the July-September earnings season, S&P 500/400/600 forward earnings continued to rise in record-high territory through the week of August 10 (*Fig. 7*). The earnings estimates for 2018 continue to hold up remarkably well, which is a big arithmetic plus for forward earnings, since it is a time-weighted average of consensus earnings estimates for the current year (2017) and the coming year (2018). The same can be said of S&P 500/400/600 forward revenues, which also are rising in record-high territory across the board (*Fig. 8*).

(2) *Earnings hooks.* The traditional earnings hooks were visible during the Q2 earnings season as results turned out to be better than estimates at the beginning of the earnings season (*Fig. 9*).

(3) *Outlook.* Joe and I need to tweak our S&P 500 earnings-per-share estimate. We are raising it from $130 to $131. The outlook for 2018 depends a lot on the prospects for the Trump administration to focus on tax reform. Most Washington watchers seem to have concluded that not much can be done or will be done. Given how badly the Republicans have failed to pass any Republican agenda item despite their majorities in both houses of Congress, they might be under a lot of pressure to give the voters something good before the mid-term elections next year. That would be tax reform.

Our S&P 500 earnings forecast for 2018 is $136.75 assuming no reduction in the corporate tax rate. It is currently set at a statutory rate of 35.0% (*Fig. 10*). However, Joe observes that the effective rate fell from 27.5% in 2015 to 26.4% last year (*Fig. 11*). Here are our estimates at lower statutory rates—assuming that they are also the effective rates, with the elimination of deductible expenses as a quid pro quo for the lower tax rate: $141.50 (20% rate) and $150.00 (15% rate).

CALENDARS

US. Tues: Richmond Fed Manufacturing Index 11, FHFA Price Index 0.5%. **Wed:** New Home Sales 610k, Composite, Manufacturing, and Non-Manufacturing PMI Flash Estimates 54.3/53.2/54.8, MBA Mortgage Applications, EIA Petroleum Status, Kaplan. (Bloomberg estimates)

Global. Tues: Eurozone ZEW Economic Sentiment Index, Germany ZEW Economic Sentiment Index 15, Canada Retail Sales 0.3%. **Wed:** Eurozone Consumer Confidence -1.8, Eurozone Composite, Manufacturing, and Non-Manufacturing PMI Flash Estimates 55.5/56.3/55.4, Germany Composite, Manufacturing, and Non-Manufacturing PMI Flash Estimates 54.7/57.7/53.3, France Composite, Manufacturing, and Non-Manufacturing PMI Flash Estimates 55.5/54.5/55.8, Japan M-PMI Flash Estimate, Draghi. (DailyFX estimates)

STRATEGY INDICATORS

YRI Weekly Leading Index (*link*): Our Weekly Leading Index (WLI)—a good coincident indicator that can confirm or raise doubts about stock market swings—rose by 3.2% during the five weeks ending August 12, after falling six of the prior seven weeks by 3.6%; it's now within only 0.5% of its record high recorded 12 weeks ago. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). Our BBB also climbed 3.2% over the five-week period, after contracting 4.5% over the prior seven-week period; it's 1.4% below its record high posted during the week of May 20. Jobless claims sank for the fifth week to 240,500 (4-wa) after rising from 235,500—which was the lowest since April 1973—to 246,000 the prior seven weeks. The CRB raw industrial spot price index—another BBB component—continued to move higher. Meanwhile, the WCCI climbed for the fifth week, by a total of 10.9%, more than reversing the 8.2% decline the prior six weeks.

S&P 500/400/600 Forward Earnings (*link*): LargeCap forward earnings rose to a record high last week, but MidCap's and SmallCap's edged down. MidCap dropped for the first time in 27 weeks to 0.1% below its prior week record high, but SmallCap was down for a fourth straight week to 1.2% 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 ticked down to 9.7% y/y from 9.8% a week earlier, which compares to a 64-month high of 10.2% in mid-May and a six-year low of -1.8% in October 2015; MidCap's was down to 13.8% y/y from a 66-month high of 14.0%, which compares to a six-year low of -1.3% in December 2015; and SmallCap's dropped to a seven-month low of 9.9% from 10.9%, 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's 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 11.5% and 10.9%, MidCap 11.6% and 12.9%, and SmallCap 6.2% and 20.3%.

S&P 500/400/600 Forward Valuation (*link*): Forward P/E ratios fell 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 are easing now after melting 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 dropped to an 18-week low of 17.2 from 17.4, 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 Tech bubble's record high of 25.7 in July 1999. MidCap's forward P/E edged down to a post-election low of 17.2 from 17.3, 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 also down to a post-election low of 18.4 from 18.6, 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, but down 2.5 points from SmallCap's record-high P/E of 20.9 in April 2002. Looking at their daily forward price/sales (P/S) ratios since data became available in 2004, valuations last week were similarly lower for the three indexes: LargeCap's P/S of 1.92 on Friday is down from a record high of 1.97 in late July; MidCap's 1.21 is down from a record high of 1.39 in early March, and SmallCap's 0.94 is down from 1.08 in early March and its 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 mixed last week as analysts' post-Q2 earnings season revision activity slowed. The Q3 consensus rose w/w for three of the 11 S&P 500 sectors, fell for three, and was steady for four. Sectors with rising Q3 estimates last week: Telecom (0.6%), Financials (0.4), and Tech (0.2). Last week's decliners: Consumer Discretionary (-0.2), Utilities (-0.2), and Consumer Staples (-0.1). The S&P 500's Q3-2017 EPS forecast fell 7 cents w/w to $33.19, and is down 1.9% from $33.82 at the end of Q2. That represents a forecasted pro forma earnings gain for Q3-2017 of 6.7% y/y, down from Q2's blended 12.1% 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 6.8% 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 three. Real Estate's Q3 forecast has risen 2.5%, Tech's is up 1.2%, and Telecom has gained 0.6%. Energy's has tumbled 19.5% for the worst decline, followed by the Q3 forecasts for Consumer Discretionary (-4.2), Materials (-4.1), and Utilities (-2.8). The S&P 500's Q3-2017 forecasted earnings gain of 6.7% 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 6.7%. 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 (130.6% in Q3 vs 537.4% in Q2), Tech (9.8% vs. 16.4%), Industrials (7.8, 7.3), S&P 500 (6.7, 12.1), Financials (5.1, 12.1), Health Care (3.8, 8.5), Consumer Staples (3.2, 4.8), Materials (1.9, 7.7), Real Estate (3.0, 4.9), Consumer Discretionary (0.6, 3.9), Telecom (-1.1, 4.8), and Utilities (-1.9, 6.1).

S&P 500 Q2 Earnings Season Monitor (*link*): With nearly 95% of S&P 500 companies finished reporting Q2-2017 results, their revenue and earnings surprise data and y/y growth comparisons are mixed relative to the comparable point of the Q1 season. Of the 473 companies in the S&P 500 that have reported through this morning, 73% exceeded industry analysts' earnings estimates, by an average of 5.9%; they averaged a y/y earnings gain of 11.9%. 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 slightly lower 11.2% y/y. On the revenue side, 68% beat sales estimates so far, with results coming in 1.0% above forecast and 5.4% higher than a year earlier. At this point in the Q1 season, a lower 63% had exceeded forecasts, companies reported revenues a lower 0.7% above forecast, and sales rose a higher 8.4% y/y. Q2 earnings are higher on a y/y basis for 71% of companies vs 62% at the same point in Q1, and revenues are higher for 79% vs a similar 79% a quarter ago. The gulf between the percentage of companies reporting higher y/y earnings growth and the percentage of those reporting higher y/y revenue growth is the biggest since Q1-2012 and suggests that margins may be under pressure. Q2 results are not expected to change markedly as the remaining 27 companies report. The results to date suggest a return to more normalized growth rates following the Energy recession of 2015-2016. Q2-2017 marks 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.

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