Yardeni Research, Inc.

MORNING BRIEFING
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Material Improvement

See the collection of the individual charts linked below.

(1) Bears shouldn't take comfort in small-cap underperformance ytd, which may simply reflect valuation correction after Trump bump. (2) Jackie digs deep into the Materials world. (3) Why are metals so strong? (4) Mining companies are digging up profits again.

Strategy: Big Apples & Small Oranges. The Russell 2000's poor performance is one of the key items that has the bears growling lately. The small-cap stock index is up a mere 1.1% ytd through Tuesday's close compared to the S&P 500's 9.5% gain ytd. Likewise, the Russell 2000 is off 5.4% from its July high, while the S&P 500 is only 1.1% off its highest level (*Fig. 1*).

The underperformance of small-cap stocks can sometimes foreshadow an economic downturn. But the Russell 2000's lackluster returns may have less to do with economics and more to do with politics and sector weightings.

The Russell 2000 rallied 13.6% in the wake of President Trump's election through yearend 2016 on hopes that the new administration would push through tax cuts. Many small-cap stocks are domestically focused and have higher tax rates than large, international companies that can shelter their earnings in jurisdictions with low tax rates. Over the same period, the S&P 500 rallied only 4.6% and the Russell 1000 rallied 4.8%.

The P/E on small-cap stocks rose sharply—roughly three points—from the election into early December. Conversely, the multiple on large-cap stocks rose by only 0.7 point (*Fig. 2*). As 2017 ensued, and the debate over healthcare reform derailed any quick reduction to tax rates, the gains in small-cap stocks stalled.

The underperformance of the Russell 2000 can also be attributed to its sector weightings, which differ from the sector weightings in the S&P 500 in some very important ways. For example, the Russell 2000 had a 14.1% weighting of Technology stocks as of June 30. That's far less than the 23.3% weighting of Tech in the S&P 500 (*Fig. 3*). Tech has been the S&P 500's top-performing sector, returning 23.0% ytd. So the Russell's lower exposure to Tech would weigh on the index's returns.

Another big difference in the sector weightings is in the Financials sector. The Russell 2000 has a 26.3% weighting to Financials, while the S&P 500 has a 14.5% weighting (*Fig. 4*). Being more exposed to Financials may be deleterious to the Russell as the S&P 500 Financials have underperformed, returning only 6.3% ytd, below the S&P 500's 9.5% ytd return.

There are a couple of other differences between the two indexes, but they are much more minor. The S&P 500 has more exposure to Consumer Staples (8.7%) than the Russell 2000 does (2.4%), and there's no break-out for Telecommunications or Real Estate in the Russell 2000, but they do have 2.2% and 2.9% weightings, respectively, in the S&P 500. The S&P 500 Telecom sector has lost 10.3% ytd, but the Real Estate sector has gained 4.8% and Staples is up 7.1%.

If tax reform had returned to the front burner and if the Russell had more exposure to Tech and less to Financials, the index would be having a better year and bears would have less to growl about.

Industry Focus: Materials Matter. Anyone who bought metals over the past year has certainly been smart and lucky, as good times have returned to the commodities markets. Prices are up, and miners are flush (*Fig. 5*). It's the latest sign that the global economy is growing nicely.

Jackie admits: "Anytime I come across a penny—especially if it's heads up—I feel compelled to pick it up. It doesn't matter that it won't pay for a piece of penny candy anymore. I just hope it will bring good luck my way." Ancient civilizations can supposedly be thanked for this widespread superstition. They believed metals were gifts from the gods and protected against evil. Hence, the popularity of horseshoes over doorways, charm bracelets, and good luck coins. Given her attraction to things metallic, I asked Jackie to dig deeper into recent developments in the S&P 500 Materials sector. She reports on how far it has come from the dark days of 2015:

(1) *What's up*. The CRB raw industrials spot index has risen 4.3% ytd through Tuesday's close and 29.3% from its 2015 low, driven higher by both precious and industrial metals (*Fig. 6*).

(2) *Dollar doldrums.* Metals undoubtedly have benefitted from the weak dollar. The JP Morgan trade-weighted dollar index has fallen 7.9% from its January 11 peak (*Fig. 7*). The global economy has been relatively strong. Most recently, the Purchasing Managers Manufacturing Index in advanced economies came in at 54.0 in July, and it stood at 50.9 in emerging economies (*Fig. 8*).

(3) *Emerged*. The Emerging Markets MSCI stock price index has risen almost in lockstep with the CRB raw industrials spot price index. The MSCI Emerging Markets index has risen 24.4% ytd in dollars and 39.1% from its 2015 low (*Fig. 9*). This suggests that emerging economies are emerging again.

(4) *Minting money*. Higher metals prices have meant a return to profits for mining companies. Glencore—which produces coal, copper and zinc—reported a $2.5 billion gain for the first six months of this year compared to a $369 million loss last year. "Rio Tinto PLC reported a net profit of $3.3 billion in the first half, up from $1.7 billion a year earlier, fueled by a 25% gain in revenues," reported a 8/10 *WSJ* article. "Anglo American PLC reported first-half net income of $1.4 billion, compared with a net loss of $813 million last year."

Companies have used much of their cash flow to repair their balance sheets by reducing debt levels that were menacingly high during the downturn in commodity prices. "As of June, BHP, Rio Tinto, Anglo and Glencore collectively held net debt of about $44 billion, down about 50% from the end of 2014, according to a review of their earnings reports," reported a 8/22 *WSJ* article.

The S&P 500 Materials sector is expected by analysts to generate 5.9% revenue growth and 13.9% earnings growth over the next 12 months, soundly above the 10.8% earnings growth that the S&P 500 is expected to deliver over the same period. The industries in the Materials sector that offer earnings growth prospects that are faster than the S&P 500's expected earnings growth include: Copper (78.4%), Construction Materials (31.4), Steel (27.5), Fertilizers & Agricultural Chemicals (22.1), Metals & Glass Containers (19.2), Paper Packaging (18.8), and Specialty Chemicals (12.8).

Improved earnings have propelled the stocks of the metals and mining companies over the past year, as many of them defied calls of their untimely deaths and bounced off lows of early in 2016. Here are the amazing one-year stock performances of some of the sector's largest players through Tuesday's close: Glencore's ADRs rallied 85.2%, Anglo American's ADRs (52.7%), Rio Tinto's ADRs (46.0), BHP Billiton's ADRs (30.8), and Freeport-McMoRan (27.4).

It's only when you look back five or even 10 years that it becomes clear how far these names fell in the commodities recession of 2014 and 2015. Even after the amazing run over the past 12 months, these stocks all are still in negative territory measured over five years: Glencore's ADRs (-18.6%), Anglo American's ADRs (-44.8), Rio Tinto's ADRs (-2.9), BHP Billiton's ADRs (-36.0), and Freeport-McMoRan (-57.4). As long as global growth continues, these stocks will continue build on their recovery.

CALENDARS

US. Thurs: Jobless Claims 237k, Existing Home Sales 5.565mu, Kansas City Fed Manufacturing Index, Weekly Consumer Comfort Index, EIA Natural Gas Report, Jackson Hole Economic Policy Symposium. **Fri:** Durable Goods Orders Total, Ex Transportation, and Core Capital Goods -5.8%/0.4%/0.5%, Baker-Hughes Rig Count, Jackson Hole Economic Policy Symposium, Yellen. (Bloomberg estimates)

Global. Thurs: UK GDP 0.3%q/q/1.7%y/y, Japan Headline, Core, and Core-Core CPI 0.4%/0.5%/0.1% y/y. **Fri:** Germany GDP 0.6%q/q/2.1%y/y, Germany Ifo Business Climate, Current Assessment, and Expectations Indexes 115.5/125.0/106.8, Draghi. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): Our Bull/Bear Ratio (BBR) this week slipped further below 3.00. The BBR fell for the third week to 2.63 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 fourth week by a total of 12.1ppts to 48.1%—its lowest reading this year—with 9.4ppts of the drop occurring the past two weeks. Most of the bulls moved to the correction camp, with the count climbing 8.1ppts the past two weeks and 10.3ppts over the four-week period to 33.6%—to a new high for the year. Bearish sentiment ticked up 2.1ppts the past three weeks to 18.3%—holding in the narrow 16.5%-18.3% range shown most of this year. The AAII Ratio was unchanged at 51.0%, down from 58.6% three weeks ago. Bullish sentiment climbed from 33.7% to 34.2% during the week, while bearish sentiment rose the past three weeks from 24.3% to 32.8%.

EMU MSCI (*link*): The EMU's MSCI price index has gained 19.6% ytd in dollar terms after falling 1.2% in 2016. In euro terms, the price index is up a lower 7.4% ytd following a 1.8% gain for all of 2016. Euro-based forward revenues edged down 0.1% m/m, but has improved 2.8% from its six-year low in May 2016 to 1.5% below its cyclical high (August 2015) and 8.1% from its record high (September 2008). Euro-based forward earnings had stalled from 2011 to 2016—but is now 6.5% above its prior cyclical high in September 2015 to its highest level since October 2011. It remains 23.2% below its record high (January 2008), but has improved 13.8% from its 23-month low in June 2016. Analysts expect revenues to rise 5.2% and 3.4% in 2017 and 2018, respectively, after falling 1.8% in 2016, but think earnings will rise 11.4% in 2017 and 8.6% in 2018 following a 4.9% increase in 2016. Forecasted STRG of 4.0% is down from a six-year high of 5.0% in April, but up from 2.0% in May 2016. Forecasted STEG of 9.4% is down from a 78-month high of 21.0% in February, which compares to a seven-year low of 5.7% in April 2016. STEG had been higher than LTEG (12.8%) from July 2016 to May 2017, but is trailing now. The forward profit margin has improved 1.7ppts to a six-year high of 7.4% from a cyclical bottom of 6.2% in May 2013. The implied profit margin is expected to improve to 7.2% in 2017 from 6.8% in 2016 before rising another 0.3ppt to 7.5% in 2018. NERI was negative in August for the first time in nine months, falling to -2.2% from 2.9% in July. Those readings are down from a 131-month high of 8.1% in May, which compares to a 24-month low of -13.2% in April 2016. The P/E of 14.2 is down from 14.4 in July and from a 13-year high of 16.4 in April 2015, but up from a 30-month low of 12.2 in February 2016. That represents an 11% discount to the World MSCI's P/E now, up from a record-low 25% discount during 2011. But the current reading is still well below the 1% premium during April 2015—the post-euro-inception record high.

Emerging Markets MSCI (*link*): The EM MSCI price index is up 24.4% ytd in US dollar terms after rising 8.6% in 2016. In local-currency terms, EM has gained a lower 19.7% ytd compared to a 7.1% gain in 2016. Local-currency forward revenues rose 0.8% m/m and is up 5.8% from a four-year low in June 2016 to 10.9% below its November 2014 record. Local-currency forward earnings has fared substantially better, rising 1.3% m/m; it has improved 21.6% from April 2016's six-year low to just 0.6% below its January 2014 record. Revenues are expected to rise 9.7% in 2017 and 8.2% in 2018 following a 2.3% gain in 2016, leading to earnings gains of 20.3% (2017) and 11.6% (2018) following a 7.7% rise in 2016. Forecasted STRG of 8.8% is back on an uptrend since early 2016, but is down slightly from a four-year high of 9.6% in late January. STEG of 14.3% is down from 15.0% a month ago, and is below LTEG (19.9%) again. The implied profit margin is expected to improve to 6.9% in 2017 from 6.3% last year before edging up to 7.1% in 2018. The forward profit margin of 7.0% is the highest since February 2013 and up from a record low of 6.0% in February 2016, but remains more than 3ppts below its 10.3% record high in December 2007. NERI—negative for 78 months—ticked down m/m to -1.6% from -1.1%, which compares to a 75-month high of -0.6% in May and an 83-month low of -10.2% in March 2016. Emerging Markets' valuation has been more stable recently than that of the rest of the world. The P/E was down to 12.3 from an 11-month high of 12.6 in early August, which nearly matched the highest P/E since January 2010 and compares to a 17-month low of 10.2 in August 2015. The index is trading at a 22% discount to the World MSCI P/E, up from a 10-year-low 30% discount in August 2016.

MSCI World & Region Net Earnings Revisions (*link*): Analysts' recent earnings revisions through August suggest less optimism about profits across the world. All regions weakened m/m during August and are down from their multi-year highs in May. The AC World MSCI's NERI was positive for a seventh month and for the first time since June 2011, but slipped 1.3ppts to 0.6% from 1.9% in July and is down from a 74-month high of 3.3% in May. The AC World Ex-US was negative for the first time in eight months, dropping 1.0ppts to a nine-month low of -0.8% from 0.2% and is down from a 76-month high of 2.6% in May. EM Eastern Europe ended its positive NERI string at 10 months during August; Europe was negative for the first time in 11 months; EAFE was positive for a ninth month; EMU was negative for the first time in nine months. Emerging Markets' NERI was negative for a 78th straight month, paced by 74 months of negative readings for EM Asia, 13 months for EM Latin America, and 11 months for EM Eastern Europe. August's scores among the regional MSCIs: United States (4.0% in August, down from a 72-month high of 6.0% in July), AC World (0.6, 1.9), EAFE (0.0, 1.5), Europe ex-UK (0.0, 2.6), EM Eastern Europe (11-month low of 0.0, 0.2), AC World ex-US (nine-month low of -0.8, 0.2), EM Asia (-1.5, -0.7), Emerging Markets (-1.6, -1.1), Europe (11-month low of -1.8, 1.7), EMU (11-month low of -2.2, 3.0), and EM Latin America (-3.7, -3.7).

MSCI Countries Net Earnings Revisions (*link*): NERI was positive for 13/44 MSCI countries in August, the lowest since September 2016, and down from 24/44 in July and 29/44 in June, which was the highest since June 2010. NERI improved m/m in August for 14/44 countries, up from 10/44 in July, but still down from 32/44 in May, which had been the most since June 2016. Turkey's NERI was at a record high in August, followed by the Philippines' at a 49-month high, and by those of Czech Republic (27-month high), Brazil (7), and Portugal (5). On the flip side, Pakistan's was at a 99-month low, followed by those of New Zealand (48), Egypt (20), Hungary (18), Peru (17), and Australia (16). The 17-month positive NERI streak for Hungary is the best, followed by those of Austria (15), Hong Kong (10), Poland (10), and Turkey (10). Brazil's NERI has been negative for 86 straight months, followed by the negative streaks of South Africa (39), India (34), and New Zealand (15). NERI turned positive in August for Belgium. However, NERI turned negative in August for 12 countries: Chile, Denmark, Finland, France, Germany, Greece, Indonesia, Ireland, the Netherlands, Singapore, Sweden, and Switzerland. Hungary's NERI has been the strongest recently, with positive readings in 27 of the past 28 months.

US ECONOMIC INDICATORS

New Home Sales (*link*): July new home sales unexpectedly fell to a seven-month low, as builders continued to face headwinds from shortages of workers and land, along with rising materials costs. Sales slumped 9.4% to 571,000 units (saar) after jumping five of the prior six months by 15.0%. (These sales are tabulated when contracts are signed, making new home sales a timelier barometer of the residential market than existing home sales.) Sales were 8.9% below a year ago, the first yearly decline in 17 months. In July, there were 276,000 new homes on the market—the most since June 2009—but still less than half of the peak recorded during the housing boom. The months' supply of homes climbed to 5.8, the most since September 2015. On a more encouraging 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 inching up a point to 49.

GLOBAL ECONOMIC INDICATORS

US PMI Flash Estimates (*link*): Private-sector growth continued to gain momentum this month, posting its fastest growth in 27 months on a sharp acceleration in services activity. The C-PMI flash estimate climbed for the fifth month from 53.0 in March to 56.0 in August, the best reading since May 2015. The NM-PMI continued to rebound, climbing steadily from 52.8 in March to 56.9 in August—a 28-month high; the M-PMI (to 52.5 from 53.3) slipped to a two-month low this month. According to the report, the improvement in services activity was highlighted by a sharp and accelerated increase in new business, with the rate of new-order growth at a 25-month high, which boosted payrolls. As for the manufacturing sector, production this month expanded at its slowest pace in 14 months, while new business growth slowed from July's four-month high. In addition, higher raw materials prices contributed to higher production costs at factories.

Eurozone PMI Flash Estimates (*link*): Growth in the Eurozone in August continued to expand at one of the strongest rates seen over the past six years, according to Markit—led by the manufacturing sector. Meanwhile, inflationary pressures remained modest. August's flash estimate shows the C-PMI edged up from a six-month low of 55.7 to 55.8, not far from April/May's 56.8, which was the best pace since spring 2011. The M-PMI (to 57.4 from 56.6) climbed to a two-month high, while the NM-PMI (54.9 from 55.4) slipped to a seven-month low. According to the report, strength in the manufacturing sector was driven by an acceleration in both output and orders, with the latter boosted by the fastest rise in exports in six and a half years. Growth in the service sector slowed, but the rate of expansion remained solid amid a further increase in new orders. Job creation remained solid this month, though slower job growth was posted in both the manufacturing and services sectors. By country, Germany's C-PMI (55.7 from 54.7) showed growth accelerated this month, as both the M-PMI (59.4 from 58.1) and NM-PMI (53.4 from 53.1) showed an acceleration, with the former back near June's cyclical high of 59.6. France's C-PMI (55.6) showed activity remained at July's robust pace; France's M-PMI (55.8 from 54.9) showed the best growth in its manufacturing sector since April 2011, while the NM-PMI (55.5 from 56.0) revealed growth in the service sector has eased steadily since March's cyclical high of 57.5. The rest of the Eurozone saw slightly slower, though still strong, growth during the month, as a deceleration in services activity outweighed an acceleration in manufacturing activity.

Japan M-PMI Flash Estimate (*link*): Japan's manufacturing activity this month rose at the fastest pace in three months, according to its flash estimate. The M-PMI rose to 52.8 after falling the prior two months from 53.1 to 52.1, continuing to bounce around February's cyclical high of 53.3. August's report notes production, orders, and employment all accelerated, driven by a mix of stronger domestic and foreign demand.

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