MORNING BRIEFING
August 29, 2017

Theatre of the Absurd

See the collection of the individual charts linked below.

(1) Godot was a junkie. (2) If life is meaningless, what's the point of seeing a play? (3) Lucky was lucky not to have any expectations. (4) Theatre of the Absurd now playing in DC. (5) Existential crisis: Trump's tax plan doesn't exist. (6) Untouchables vs dynamic scoring. (7) Medicaid has turned into a big drug dealer. (8) Millennials coming out of their parents' caves to buy their own caves. (9) Janet Yellen vs Jeff Bezos.

US Tax Reform: Godot's Addiction. *Waiting for Godot* is a play by Samuel Beckett. It premiered on January 5, 1953 in a Parisian theater. It features two characters, Vladimir and Estragon. They are waiting for someone named "Godot" who never arrives. In a poll conducted by the British Royal National Theatre in 1990, it was voted the "most significant English language play of the 20th century." That might say more about the audience than the play because not much happens during the play. The dialogue is so nonspecific that the characters' situation is far from clear and is open to wide interpretation. Beckett didn't include any clues about the setting of the play, or about the characters for that matter. There are three other characters, who come and go. One of them is named "Lucky." When Beckett was asked why Lucky was so named, he replied, "I suppose he is lucky to have no more expectations."

Beckett's play was one of several, by various mostly European playwrights, that were collectively called the "Theatre of the Absurd" during the 1950s. It was a part of the existential (a.k.a. absurdist) philosophy, which postulated that human existence has no meaning or purpose. The plays were mostly either fashioned as comedies or tragi-comedies combining vaudeville, clichés, word games, and meaningless and/or repetitive action. The characters grapple to find significance amid hopeless circumstances in what seems like a vacuous universe.

Sounds exactly like the endless theatre of the absurd in Washington! Just like Lucky in Beckett's play, we are lucky to have no expectations. We are certainly lucky that the stock market is at a record high despite greatly reduced great expectations about the Trump administration's economic agenda.

Yesterday morning, I wrote about the administration's tax-reform plan. I noted that it will be hard to get a deal done, despite the Republicans' majorities in both houses of Congress, if it isn't deficit neutral. In other words, any tax cuts would have to be offset by significant cuts in so-called "tax expenditures," which currently exceed $1 trillion per year. The problem is that most of these items are sacred cows, with lots of high-priced lobbyists prepared to protect them. Indeed, the three biggest deductions for individuals—on charitable donations, mortgage interest payments, and retirement savings—won't be touched, according to National Economic Council Director Gary Cohn.

If the "untouchables" include not only entitlement spending but also lots of tax expenditures, then the Trump tax cuts won't be deficit neutral. The administration will have to argue that their "dynamic scoring" of the tax-reform plan shows that tax revenues will be boosted by higher economic growth resulting from the plan sufficiently to pay for the tax cuts. That's a conclusion that probably won't be confirmed by the Congressional Budget Office when it runs the numbers through its economic model. That could cost the votes of Republican fiscal conservatives in Congress, which would cause the

Republican majorities to crumble when the Trump tax-reform plan comes to a vote.

Also yesterday morning, Bloomberg posted an article titled "Trump's Pivot to Taxes Is Fraught With 'Pitfalls Everywhere'." It observed that Trump's tax-reform plan is facing an existential crisis. That's because it doesn't exist. It remains all talking points: "Instead of providing details that could help build support for a bill, the president will largely rely on the same talking points he and his advisers have highlighted since January: The middle class deserves a tax cut and businesses need changes to help them compete with global rivals." Here is another key point: "The lack of specifics has kept Washington lobbyists on the sidelines—but that could change as soon as tax writers target any treasured loopholes."

While meaningful tax reform, including a cut in the corporate tax rate, may no longer be discounted in the stock market, investors may still be anticipating that something will be done to stimulate the repatriation of $2.6 trillion in profit that US companies have stockpiled overseas. So far, the administration hasn't provided any specifics on this element of the tax plan.

What may keep the hoped-for tax reform from showing up is an addiction to government spending, especially spending on entitlements. Godot is a junkie. And he's not alone. Absurdly, many Americans who have become addicted to opioids are paying for the pain- and life-killing medication with Medicaid. Previous attempts to wean Americans off their tax deductions have failed. In Washington's theatre of the absurd, tax reform may be hopeless, certainly with the current cast of characters.

Stocks: Forget About Godot. Fortunately for stock investors, we aren't forced to watch this depressing play. A much happier one is corporate earnings, which continue to rise:

(1) *Earnings.* As Joe reviews below, forward earnings per share rose to new record highs for the S&P 500 and S&P 400 last week (*Fig. 1*). It has edged down from its record high in mid-July for the S&P 600. Estimates for 2018 are holding up very nicely, implying earnings growth rates for the S&P 500/400/600 of 11.0%, 13.0%, and 20.5%.

(2) *Revenues.* S&P 500/400/600 forward revenues per share also rose to new highs two weeks ago (*Fig. 2*). Growth rates for the three during 2018 are currently estimated at 4.9%, 4.5%, and 5.2%.

(3) *Profit margins*. The S&P 500 forward profit margin rose to a record high of 11.1% two weeks ago (*Fig. 3*).

US Consumers: Godot Is Coming! Melissa and I have been waiting for Millennial Godots to show up in the suburbs. Some of them have been out there, but living in their parents' basements for lack of a good job—or lack of interest in finding any job, getting married, having kids, and buying houses and cars. Most of the Millennials have been extending their stays in college, and accumulating lots of student loans, which also delay them from getting married, having kids, and buying houses and cars.

But they may be coming on stage now. They were spotted doing so by an 8/22 Bloomberg article titled "Millennial Americans Are Moving to the 'Burbs, Buying Big SUVs." According to the story, "Millennials are finally starting their own baby boom and heading for the suburbs in big sport utility vehicles, much like their parents did. Americans aged about 18 to 34 have become the largest group of homebuyers, and almost half live in the suburbs, according to Zillow Group data. As they shop for bigger homes to accommodate growing families, they're upsizing their vehicles to match. U.S. industry sales of large SUVs have jumped 11 percent in the first half of the year, Ford Motor Co. estimates, compared with increases of 9 percent for midsize and 4 percent for small SUVs."

Significantly, “Millennials ranked having children, buying a suburban home and driving a big family vehicle higher in terms of importance than living in a major city or relying on alternate forms of transportation in a survey that Ford conducted in June.” The hard data may be starting to confirm these sightings:

(1) *Household formation.* The pace of household formation has actually slowed recently (*Fig. 4*). The number of households fell to 118.4 million in June from a record high of 119.2 million during May. Over the past 12 months through June, only 100,000 households were formed, down from a recent high of 1.5 million in the 12 months through February (*Fig. 5*).

(2) *Owners vs renters.* Quarterly data are available showing how many of the new households are renters versus owners of their homes. Of the 0.6 million in net new households over the past four quarters, based on the quarterly average, 1.3 million were owners as the number of renters dropped 0.7 million (*Fig. 6* and *Fig. 7*). That decline in renters was the first since Q3-2004! The increase in owners was the most since Q1-2005.

This all augurs well for single-family housing starts, and not so well for multi-family starts (*Fig. 8* and *Fig. 9*). This development has yet to show up in a slower pace of tenant rent inflation as measured in the CPI (*Fig. 10*).

By the way, the suburban legend about lots of Millennials staying at home with their parents is a bit of a myth. It seems that many Millennials are delaying their transition from childhood to adulthood with a period of “emerging adulthood,” according to an April 2017 Census Bureau study titled *The Changing Economics and Demographics of Young Adulthood: 1975-2016*. It reported that 31% of young people, or 22.9 million 18- to 34-year-olds, lived in their parents’ home in 2016. That’s more than in any other living arrangement. It is up from 26% in 1975. The percentage living with a spouse dropped to 27% in 2016 from 57% in 1975. This strongly suggests that while many young adults were no longer childish, they had become “adultish,” i.e., still very dependent on their parents.

The news media accurately reported that the Census numbers show that one out of three young adults still lives at home. But Melissa found something wrong with the picture that statistic paints; buried in a footnote was this information: “College students who are living in dormitories are counted as living in the parents’ home.” So the widespread notion that Millennials are living in the furnished basements of their parents’ home and playing video games all day is a myth. On the other hand, the Census study found that 25% of young people living in their parents’ home neither go to school nor work. This figure represents about 2.2 million 25- to 34-year-olds, or about 8% of them.

Inflation: Godot Remains MIA. If rent inflation starts to moderate as the latest owners-vs-renters household formation data suggest should happen, then the Fed’s 2.0% target for the PCED inflation rate will be harder to achieve (*Fig. 11*). I never quite understood why the members of the FOMC are so intent on raising inflation, especially since it has been mostly propped up by rent and medical care inflation.

In any case, instead of Godot (the widely anticipated inflation character) showing up, the stage is now dominated by a much more powerful new character—Jeff Bezos. He is the Deflator from Amazon. Yesterday, Amazon.com Inc. spent its first day as the owner of brick-and-mortar grocery chain Whole Foods Market cutting prices as much as 43%. I wonder if any of the members of the FOMC have ever ordered anything from Amazon.

Forget about the Theatre of the Absurd. In the real world, the boxing match between Janet Yellen and Jeff Bezos is much more interesting. My money is on the Great Deflator.

CALENDARS

US. Tues: Consumer Confidence Index 120.0, S&P Corelogic Case-Shiller HPI 0.5%m/m/5.7%y/y. **Wed:** GDP & PCE 2.8%/3.0%, Corporate Profits, ADP Employment 182k, MBA Mortgage Applications, EIA Petroleum Status, Powell. (Bloomberg estimates)

Global. Tues: Germany Gfk Consumer Confidence 10.8, France GDP 0.5%q/q/1.8%y/y, Japan Retail Trade 0.3%m/m/1.0%y/y. **Wed:** Eurozone Economic Confidence 111.3, Germany CPI 0.1%m/m/1.8%y/y, UK Gfk Consumer Confidence -13, Japan Industrial Production 5.1% y/y, Japan Small Business Confidence. (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—reached a new record high during the week of August 19. The WLI rebounded by 4.3% during the six weeks ending August 19, after falling six of the prior seven weeks by 3.6%. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). Our BBB jumped 4.6% over the six-week period, back up at its record high posted during the week of May 20. Jobless claims sank for the sixth week to 237,750 (4-wa), back near the 235,500 reading in late May—which was the lowest since April 1973; claims were at 246,000 six weeks ago. The CRB raw industrial spot price index—another BBB component—continued to move higher. Meanwhile, the WCCI climbed for the sixth week, by a total of 12.3% to a new cyclical high.

&P 500/400/600 Forward Earnings (*link*): Forward earnings rose to a record high last week for LargeCap and MidCap, SmallCap's remained 1.2% below its mid-July record despite rising for the first time in five weeks. 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 remained steady at 9.7% y/y, 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 13.5% y/y from 13.8%, which compares to a 66-month high of 14.0% in early August and a six-year low of -1.3% in December 2015; and SmallCap's improved to 10.2% from a seven-month low of 9.9%, 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 11.0%, MidCap 11.6% and 13.0%, and SmallCap 5.7% and 20.5%.

S&P 500/400/600 Forward Valuation (*link*): Forward P/E ratios edged higher 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 rose to 17.3 from an 18-week low of 17.2, 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 up to 17.3 from a post-election low of 17.2 a week earlier, 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 rose to 18.6 from a post-election low of 18.4, 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 1.94 on Friday is down from a record high of 1.97 in late July; MidCap's 1.23 is down from a record high of 1.39 in early March, and SmallCap's 0.95 is down from 1.08 in early March and its record high of 1.17 in November 2013.

US ECONOMIC INDICATORS

Regional M-PMIs (*link*): Five Fed districts now have reported on manufacturing activity for this month—New York, Philadelphia, Richmond, Kansas City, and Dallas—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 more than reversed July's slowdown, rebounding to 18.2 from 14.0 in July; it was at 23.9 in February—which was the highest reading since July 2004. The New York (to 25.2 from 9.8) and Kansas City (16 from 10) measures accelerated sharply this month, with the former recording its best growth since September 2014, while Philadelphia's (18.9 from 19.5), Dallas' (17.0 from 16.8), and Richmond's (unchanged at 14) continued to expand at a robust pace. The new orders gauge gained momentum for the second time in three months, increasing from 10.0 in May to a five-month high of 19.5 this month, as billings in the New York (20.6 from 13.3), Philadelphia (20.4 from 2.1), and Kansas City (25 from 10) districts all accelerated sharply, while Richmond's (17 from 18) and Dallas' (14.3 from 16.1) grew around July's robust pace. The employment measure climbed to 11.4 after slowing steadily from March's cyclical high of 13.1 to 10.2 last month, led by a sharp pickup in hiring in the Richmond (17 from 10) district. Philadelphia (10.1 from 10.9), Kansas City (14 from 15), and Dallas (9.9 from 11.2) manufacturers continued to expand payrolls at a solid pace, while those in New York (6.2 from 3.9) added to payrolls at a slightly faster pace this month, after slowing to a five-month low in July.

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