MORNING BRIEFING
August 31, 2017

Store Wars

The next *Morning Briefing* will be sent on Tuesday, September 5.

See the collection of the individual charts linked below.

(1) New age for supermarkets. (2) From King Kullen to Amazon. (3) Clash of the Titans: Sam vs Alexa. (4) Amazon is subduing inflation and frustrating Fed's inflation target practice. (5) Google teams up with Wal-Mart. (6) Kiosks are the new fast food takeout window. (7) Amazon has the Cloud advantage. (8) India's manufacturing takes a hit. (9) More bad loans in India. (10) Capital inflows still strong for India.

Industries: Targeting Alexa. "World's Greatest Price Wrecker" is a moniker that seems appropriate for Amazon, especially after the price cuts it announced earlier this week at its new subsidiary, Whole Foods. However, the phrase actually dates back to the 1930s. It was used in ads by Michael J. Cullen, who's widely credited with having had the idea for supermarkets. During an era of mom-and-pop enterprises, the suggestion of "monstrous" stores, with plenty of parking, separate departments, self-service, discount pricing, and high-volume sales was revolutionary.

When Cullen's idea was ignored by his then-employer Kroger Grocery & Baking Co., he struck out and opened King Kullen on Long Island. Ads for the new enterprise cried out: "King Kullen: World's Greatest Price Wrecker." King Kullen continues today as a family-controlled operation on Long Island with 32 locations.

Now King Kullen and other grocers need to evolve in response to Amazon's arrival. We spill a lot of ink tracking Amazon because it's disrupting so many different industries across the world of retailing (clothing, office supplies, food, etc.), entertainment, and technology (Alexa, Kindle, web services). Amazon is also affecting the broader economy, as the competition and lower prices it typically offers are helping to subdue inflation and preventing the Fed from achieving its 2% inflation target.

The most recent reminder of Amazon's influence came last week when Whole Foods slashed prices on certain items. The move shook investor confidence in food retailers and suppliers alike. The S&P 500 Food Retail stock price index, which holds Kroger shares, has fallen 19.5% ytd through Tuesday's close (*Fig. 1*). Likewise, the S&P 500 Packaged Foods & Meats stock price index, which contains General Mills, Campbell Soup, and others, has lost 6.9% (*Fig. 2*).

One related industry that hasn't lost ground this year is Hypermarkets & Super Centers, which includes Wal-Mart and Costco. It's up 8.3% ytd (*Fig. 3*). The gains are thanks to Wal-Mart, as the giant retailer's shares are up 14.0% ytd, ahead of the S&P 500's 9.3% advance.

Why would Sam Walton's creation be faring so well in the face of growing competition? We have two possible explanations. In anticipation of Amazon's arrival to the world of bricks and mortar, Wal-Mart has made numerous acquisitions and introduced new, competitive offerings that are having a positive impact on business. Another possibility: The continued downward spiral of Sears and Kmart is helping Wal-Mart land new business. I asked Jackie to take a gander at why Wal-Mart's shares have eluded the bargain bin. Here are her findings:

(1) *Hey, Google.* Wal-Mart may not be the first to introduce a new technology, but it certainly knows how to copy a good idea when it sees one. Earlier this month, Wal-Mart announced plans to team up with Google to compete with Amazon's Alexa. Wal-Mart will share its consumers' purchase history with Google, and Wal-Mart customers will have access to Google's online-shopping marketplace, Google Express. Google Express can be accessed by speaking to Google's virtual assistant, which sits in phones and in Google's voice-controlled speaker, Google Home.

As an 8/23 *WSJ* article explained, "The increasing importance of voice shopping suggests Wal-Mart and Google, part of Alphabet Inc., need each other to compete against Amazon. Voice-controlled ordering is a small but rapidly growing share of online sales, analysts say, and one of the top reasons to use Amazon's virtual assistant Alexa and its Echo speakers." Wal-Mart will be available on the service in September.

Wal-Mart is also introducing new functions that make shopping easier. It launched Easy Reorder, which lists a consumer's purchases made online and in-store and makes them available for purchase. It has teachers' school supply lists available on Walmart.com, and just clicking on the listed items puts them in your cart. The website also has a section dedicated to students shopping for college.

(2) *Efficiency rules*. In an attempt to keep costs down, Wal-Mart is introducing in-store kiosks from which customers can pick up goods ordered online. Customers access their order by scanning a barcode in the machine. "The massive orange towers stand 16 feet tall by 8 feet wide and deliver items through a conveyor belt inside the contraption," a 7/6 AOL article explained. Packages are loaded into the kiosk by workers.

Wal-Mart is also experimenting with a kiosk for groceries that stands in a store's parking lot. Consumers order in advance online, and Wal-Mart employees gather the items and store them in the 20-foot-by-80-foot refrigerated kiosk, according to a 6/6 Business Insider article. Customers walk up to the kiosk anytime day or night, type in a code, and their groceries are dispensed.

Other initiatives: Wal-Mart employees who opt into a program can deliver packages ordered online on their way home from work. The company is offering discounts to customers who ship purchases, especially large items, to Wal-Mart stores. And perhaps most importantly, the company introduced free two-day shipping on orders over $35 on more than 2 million items. Take that, Amazon Prime.

"We believe that we're uniquely positioned to grow and delight customers by providing the seamless shopping experience they desire. Having stores within 10 miles of approximately 90% of the U.S. population allows us to serve customers in ways that are most convenient for them," said Wal-Mart's CEO Douglas McMillon, according to the company's Q2 conference call transcript.

Wal-Mart has online grocery service in more than 900 of its US locations. In the US, there are 4,741 Wal-Mart stores compared to 444 Whole Foods stores.

(3) *Winners and losers*. The slow demise of Sears and Kmart shouldn't be underappreciated in Wal-Mart's success. Sears, of course, was the Amazon of the 1920s and '30s. Its catalogs, offering a wide range of merchandise at low prices, dominated the industry. And when the automobile came along, Sears rapidly opened stores that ultimately overshadowed its catalog business.

These days, Sears and Kmart are shrinking. Kmart's Q2 same-store sales declined 9.4%, and at Sears they fell 13.2%. Shoppers likely will head elsewhere as Sears Holdings continues shuttering stores. At the start of the year, the company had 735 Kmarts and 670 Sears. That's down from 979 Kmarts and 709 Sears just two years prior. And the footprint will continue to shrink as the closure of 178 Sears and Kmart stores is planned for this year.

(4) *Jetting higher*. Wal-Mart's Q2 online sales rocketed higher by 60% y/y, helped by the company's September 2016 acquisition of Jet.com. Wal-Mart followed up with acquisitions of Moosejaw, Shoebuy, and Bonobos, as well as the rollout of online grocery delivery. Total sales rose 2.1% y/y to $123.4 billion, while the gross margin narrowed by 0.11pps, and adjusted EPS rose by a penny to $1.08. For the full year, the company is expected to earn $4.37 a share, basically flat from last year's $4.38 EPS.

Here's the rub: Wal-Mart doesn't have a rapidly growing cloud service that throws off oodles of profit. As long as Amazon has Amazon Web Services (AWS), it can sell consumers bananas at a loss. And that's a problem for everyone in the industry.

"AWS's juicy operating profit margin of more than 25% gives Amazon a way to fund its new ventures and a retail business that has notoriously skinny margins. The cash and financial flexibility AWS provides ensures that Amazon will be a lethal competitor in the retailing industry for many years to come," we wrote in the 3/30 *Morning Briefing*. It's dilemma that we have no doubt Michael Cullen would understand.

India Update: What a Difference a Month Makes. Forget April. August can be the cruelest month when it comes to the stock market. The MSCI India share price index fell 2.4% in US dollars from 8/1 through 8/29 after rising 28.4% ytd through 7/31 (*Fig. 4*). The BSE-Sensex hit a new high of 32,575.17 on 8/1 and as of 8/30 stood at 31,646.5, down 2.9% in that short span. We weighed in on India in the 7/20 *Morning Briefing*, noting the stock market was vulnerable to a correction and highlighting the disconnect between a slowing economy and a soaring stock market.

Since our commentary, the July reading of Indian manufacturing activity contracted sharply, dropping to the lowest level since February 2009, according to a piece in the 8/1 *FT*, as confusion surrounding a new multi-tiered goods and services tax that went into effect on 7/1 is hampering Indian businesses. India's central bank cut the benchmark interest rate by 25 basis points to 6.00%, the lowest level in more than six years. Bad loans at state-owned banks have surged, fueling worries about the health of financial institutions. Consumer prices ticked sharply higher in July, the first acceleration in four months.

Also, shares of software outsourcing powerhouse Infosys plunged following the abrupt 8/18 resignation of CEO Vishal Sikka amid boardroom intrigue and challenging conditions in its core business, dragging down the broader market. Geopolitical tensions in the region have weighed on stocks too. And for the first time in 21 weeks, emerging market funds witnessed outflows during the week of 8/16, as investors yanked $1.7 billion from stock and bond funds dedicated to developing nations, Bloomberg reported in an 8/21 story.

Despite the recent weakness, India is among the 15 top-performing markets ytd through 8/29, up 25.4%. It remains susceptible to setbacks as the MSCI India index continues to trade at elevated levels: Its forward P/E of 18.2 is well above its forward earnings growth rate of 14.5% (*Fig. 5* and *Fig. 6*). I asked Sandy to take a closer look at recent developments in India. Here's what she says:

(1) *Manufacturing slowdown.* The Nikkei India M-PMI registered 47.9 in July—the below 50.0 level signaling a contracting manufacturing economy (*Fig. 7*). The latest M-PMI reading was down sharply from June's 50.9 level and marked the lowest level in eight years. The folks at IHS Markit, which compiles the PMI data, noted that new orders and output dropped for the first time this year, according to an 8/1 release by IHS Markit. Principal economist at IHS Markit, Pollyanna De Lima, said, "The

downturn was broad-based across all subsectors covered by the survey, with output scaled back among firms in the consumer, intermediate and investment goods categories amid falling order books." The slowdown was blamed widely on confusion related to the 7/1 introduction of the goods and services tax. On the other hand, manufacturing conditions across Southeast Asia slowed, with five of seven countries in the region showing economic contraction, according to an 8/10 article in the *Nikkei Asian Review*.

(2) *Exports slowing.* India notched its 11th straight month of export growth in July, based on the 12-month percent change, but the rate of growth was at an eight-month low (*Fig. 8*). Ganesh Kumar Gupta, the president of the Federation of Indian Export Organizations, said, "A rising rupee and a not-so-encouraging order book position could make it difficult for the country to achieve the full-year export target of $325 billion," according to an 8/15 Scroll Today News story. "The order booking position from October onwards is not very promising and the appreciation of [the] Indian Rupee with increasing pressure on liquidity under GST may affect exports in the last quarter of 2017 bringing exports to about $310 billion in the current fiscal," Gupta said.

(3) *Interest-rate easing.* The Reserve Bank of India, as expected, cut rates to 6.00% from 6.25% on 8/1 in response to the economic slowdown (*Fig. 9*). The central bank noted a "weakening of the industrial performance" from April to June, when output of consumer durables and capital goods both contracted and pointed to "continuing retrenchment of capital formation in the economy," according to an 8/2 article in the *FT.* The central bank also noted that the announcement of investment projects in the quarter fell to a 12-year low.

In announcing the rate action, the RBI adopted a cautious tone toward future rate cuts, noting that it expected prices to begin rising sharply in August, the *FT* article noted. Muted consumer demand and high debt levels are expected to blunt the effectiveness of the RBI easing. Along those lines, state-owned banks are reluctant to lend and are not reducing their base lending rates proportionately.

(4) *Rising prices.* As if on cue, consumer prices ticked higher for the first time in four months, rising 2.4% y/y in July from 1.5% in June (*Fig. 10*). Housing, energy, and clothing gained, while the decline in food prices slowed significantly, as did that of vegetable prices.

(5) *Bad loans.* India's largest lender, the State Bank of India, revealed its ratio of non-performing loans jumped to nearly 10% at the end of June, from 6.9% in March. SBI's profit fell 20% as it increased reserves for the bad loans. Weak asset quality is a problem plaguing all the state-owned banks, noted an 8/11 article in the *FT*. An 8/17 *WSJ* piece reported that more than 9% of all bank loans in India are considered non-performing, the highest percentage of the largest developing nations except for Russia. Bad loans are crimping lending and investment and contributing to the economic slowdown. The Reserve Bank of India has ordered banks to initiate bankruptcy proceedings against 12 large companies with high levels of loan defaults, mainly to the steel, textile, and construction industries, according to a 6/14 story from The Wire.

These issues for the Indian economy are beginning to weigh more heavily on investors' minds if recent stock market action is any guide. The good news is that international capital flows remain very positive. We monitor a monthly proxy for such flows simply by subtracting India's 12-month trade balance from the 12-month change in the non-gold international reserves held by the country (*Fig. 11* and *Fig. 12*). This calculation shows net capital inflows since the start of the data in 1997. They dipped to a recent low of $103.9 billion at the end of last year, but recovered smartly to $159.7 billion during July.

CALENDARS

US. Thurs: Personal Income & Consumption 0.4%/0.4%, Headline & Core PCED 1.4%/1.4% y/y, Jobless Claims 237k, Pending Home Sales 0.4%, Chicago PMI 58.6, Weekly Consumer Comfort Index, Challenger Job-Cut Report, EIA Natural Gas Report, Kaplan. **Fri:** Total & Private Nonfarm Payroll Employment 180k/179k, Unemployment Rate 4.3%, Average Hourly Earnings 0.2%m/m/2.6%y/y Average Workweek 34.5hrs, Total & Domestic Motor Vehicle Sales 16.7mu/12.8mu, Construction Spending 0.6%, Consumer Sentiment Index 97.4, ISM M-PMI 56.6, Baker-Hughes Rig Count. (Bloomberg estimates)

Global. Thurs: Eurozone Headline & Core CPI Flash Estimate 1.4%/1.2% y/y, Eurozone Unemployment Rate 9.1%, Germany Unemployment Change & Unemployment Rate -6k/5.7%, Germany Retail Sales -0.6%m/m/2.9%y/y, Canada GDP 3.7%q/q/4.1%y/y, Japan Housing Starts 995k. **Fri:** Eurozone, Germany, France, and Italy M-PMIs 57.4/59.4/55.8/55.3, Italy GDP 0.4%/1.5%, UK M-PMI 55.0, Japan M-PMI, China Official & Caixin/Markit M-PMIs 51.3/51.0. (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 fourth week to 2.59 after climbing the prior three weeks from 2.69 to 3.70—which was the highest since the last week of February. Bullish sentiment ticked up to 49.5% after sliding the prior four weeks by a total of 12.1ppts to 48.1%—which was its lowest reading this year. The correction count edged down to 31.4% after climbing 10.3ppts over the previous four-week period to 33.6%—which was a new high for this year. Meanwhile, bearish sentiment rose for the fourth week from 16.2% to 19.1% over the period, moving above the narrow 16.5%-18.3% range shown most of this year. The AAII Ratio sank from 51.0% to a 14-week low of 42.3% last week as bullish sentiment fell from 34.2% to 28.1% and bearish sentiment rose from 32.8% to 38.3%.

S&P 500 Earnings, Revenues & Valuation (*link*): S&P 500 consensus forward revenues edged up w/w for the sixth time in seven weeks to less than 0.1% below its early August record high, and forward earnings rose w/w to a new record high. The forward profit margin forecast was steady w/w at 11.0%, down from a record high of 11.1% three weeks ago. The profit margin's record high was 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 was steady w/w at 5.3%, 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 was steady at a five-month low of 10.8%, which compares to 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 9.2% is 1.6ppts lower. However, the S&P 500 ex-Energy forward profit margin edged down w/w to 11.6% from a record high of 11.7%, which was its first since August 2007. Due to the w/w drop in the index price, valuation fell to 17.5 from 17.7 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 fell to 1/94 from 1.96, slightly below late July's record high of 1.97. On an ex-Energy basis, valuation dropped to a 14-week low of 17.2 from 17.4, which compares to late July's 21-week high of 17.5 and 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 7/11 sectors, and forward earnings rose for 2/11. Industrials 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 remains near a 10-month low, and its forward earnings is around an eight-month low. The forward P/S ratio rose w/w for 2/11 sectors, and the P/E ratio also rose w/w for 2/11 sectors. These two sectors saw both measures rise w/w: Real Estate and Utilities. Health Care had been surging recently; but its P/E of 16.0 and P/S of 1.71 are now 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 13.7, 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 1.25 compares to a record high of 1.56 in May 2016, and its P/E of 26.3 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. Telecom had its forecasted 2017 margin weaken 0.1ppt w/w. 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 (11.3, 11.2), Utilities (11.1, 11.4), S&P 500 (10.6, 10.1), Health Care (10.5, 10.3), Materials (9.8, 9.4), Industrials (9.2, 8.9), Consumer Discretionary (7.4, 7.2), Consumer Staples (6.5, 6.4), and Energy (3.9, 1.1).

US ECONOMIC INDICATORS

ADP Employment (*link*): According to ADP, "The job market continues to power forward. Job creation is strong across nearly all industries, company sizes. Mounting labor shortages are set to get much worse." (The report noted that the initial BLS employment estimate for August is often very weak due to measurement problems, and is subsequently revised higher. The ADP number, however, is not impacted by those problems.) Private industries added 237,000 to payrolls in August, following a big upward revision to July (to 201,000 from 178,000) and a smaller upward revision to June (192,000 from 191,000), for a net gain of 24,000. In August, service-providing industries (204,000) accounted for the majority of the gain, though goods-producing industries (33,000) posted their best performance in months with both construction (18,000) and manufacturing (16,000) jobs accelerating. Within service-providing, the biggest increases came from trade industries (56,000)—adding the most jobs since the end of last year, followed by robust gains in leisure & hospitality (51,000) and health care & social assistance (42,000) jobs. Large companies (115,000) moved from the bottom of the leader board to the top last month, posting its biggest advance since the end of 2014, with service-providing industries (104,000) accounting for 90% of the gain. Medium-sized companies slipped to the number-two spot, adding 74,000 to payrolls—with the mix 61,000 services and 13,000 goods-producing. Small-business employment increased 48,000, led by service-providing (39,000), though goods-producing (9,000) industries recorded the best job gain in four months.

GDP (*link*): Real GDP expanded a revised 3.0% (saar) last quarter—the fastest growth rate since Q1-2015—up from the advance estimate of 2.6% and nearly triple Q1's 1.2% rate. Both consumer (to 3.3% from 2.8%, saar) and business spending (6.9 from 5.2) were stronger than first reported, with the former posting its best growth in a year. Within consumer spending, growth in durable goods (8.9 from 6.3), nondurable goods (4.3 from 3.8), and services (2.1 from 1.9) consumption were all revised higher, as were the main components of business spending—nonresidential structures (6.2 from 4.9), intellectual property products (4.9 from 1.4), and equipment (8.8 from 8.2). Also contributing to growth last quarter were trade—with exports (3.7) outpacing imports (1.6) more than 2 to 1—and federal government spending (1.9%, saar), which recorded its first gain in three quarters. Detracting from Q2 growth were declines in residential investment (-6.5) and state & local government spending (-1.7).

Contributions to GDP Growth (*link*): Real consumer spending once again was the number-one contributor to real GDP last quarter, while residential investment was the biggest drag on growth. Some details: (1) Real consumer spending accounted for 2.28ppts of real GDP growth during Q2 as goods consumption added 1.27ppt—durable (0.65ppt) and nondurable (0.62)—while services contributed 1.00ppt. (2) Nonresidential fixed investment (0.85ppt) also contributed positively to GDP growth as spending on equipment (0.47), intellectual property products (0.20), and structures (0.18) were all in the plus column. (3) Trade (0.21) added to growth for the second consecutive quarter after detracting from growth at the end of last year; exports contributed 0.45ppt during Q2, while imports subtracted -0.23ppt. (4) Inventory investment (0.02) was a small contributor to GDP growth—entirely nonfarm-related (0.15)—while (5) real government spending (-0.05) was a small detractor from Q2 GDP, as a negative contribution from state & local governments (-0.18) more than offset a positive contribution from the federal government (0.13). (6) Residential investment (-0.26) was the largest negative contributor after adding to growth the previous two quarters.

GLOBAL ECONOMIC INDICATORS

Eurozone Economic Sentiment Indicators (*link*): The August Economic Sentiment Index (ESI) for the Eurozone (+0.6 points to 111.9) reached its highest level in more than 10 years, while the EU's (-0.3 points to 111.9) eased slightly from July's 10-year high. This month, ESIs for three of the five largest Eurozone economies improved. ESIs for Italy (+3.6 to 109.1), France (+1.7 to 110.6), and Spain (+1.4 to 109.3) posted solid gains, with France's climbing to a new cyclical high. Meanwhile, ESIs in Germany (-0.6 to 111.9) and the Netherlands (-0.9 to 109.0) moved lower—the former from July's cyclical high. At the sector level, increases in services (+0.7 to 14.9), industry (+0.6 to 5.1), and consumer (+0.2 to -1.5) confidence more than offset declines in retail trade (-2.3 to 1.6) and construction (-1.5 to -3.3) confidence, with services and industry confidence both reaching new cyclical highs.

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