MORNING BRIEFING
October 5, 2017

Gushing Over Global Growth

See the collection of the individual charts linked below.

(1) Five reasons why global growth is so good. (2) Global Growth Barometer has a sunny disposition. (3) On the margin, global oil demand is rising a bit faster than supplies. (4) Three geopolitical hot spots for oil. (5) US frackers should be ordering more rigs soon. (6) Electric cars are heading our way. (7) Lots of big gains underneath surface of this year's bull market. (8) Aerospace & Defense flying too high?

Global Economy: Sunny Barometric Readings. Debbie and I have observed in recent weeks mounting evidence of a global synchronized economic boom. On Tuesday, we listed five good reasons why this is happening: (1) Global monetary policy remains ultra-easy. (2) Chinese bank lending is at a record high. (3) The 50% cut in oil prices since mid-2014 is a big windfall. (4) Mass immigration into Europe is boosting the region's economic growth. (5) The global bull market in stocks is having a very positive wealth effect on economic growth.

While these factors have been in play for a while, it wasn't until early last year that they came together to collectively exert a stimulative effect on the global economy. This is most evident in the CRB raw industrials spot price index, which fell to a cyclical low of 398 on November 23 in reaction to the global recession in the energy business during 2015 (*Fig. 1*). This index was up 28% through Tuesday to 509. Not surprisingly, the index, which includes no oil commodities, is highly correlated with the price of a barrel of Brent crude oil, which has also made a big comeback from last year's low of $27.88 on January 20 to $59.00 on Tuesday.

We combine these two commodity prices to derive our Global Growth Barometer (*Fig. 2*). It is up from its low of 55 on January 20, 2016 to 79 on Tuesday.

Oil Industry: Back in Business. Given that our Global Growth Barometer is signaling good weather ahead for the world's economy, Jackie and I decided to have a look at how this might be impacting the S&P 500 Energy sector. Worldwide demand for oil has been stronger than expected of late, and excess inventories have slowly been draining. Can this continue? Perhaps in the short term. Long term, however, that may depend on whether higher prices lure more US frackers into the market and on how popular the electric automobile becomes. Let's take a look:

(1) *Demand is improving*. With world economies strengthening nicely as 2017 progresses, it should come as little surprise that demand for black gold also has been stronger than anticipated. In its latest outlooks, the International Monetary Fund (IMF) projects that world real GDP will rise 3.5% y/y this year and 3.6% next year, matching the IMF's April projections. The International Energy Agency now expects oil consumption in 2017 to increase by 1.6 mbd to 97.7 bd, according to its 9/13 report—just the latest in a series of gradually rising demand forecasts by the agency (up from a 1.4 mbd increase in July and 1.5 mbd in August).

Some of the projected demand increase is coming from the US, where crude consumption is expected to jump from 19.63 mbd last year to 19.87 mbd this year. European demand is expected to go from 14.05 mbd last year to 14.25 mbd this year, and China's consumption should jump from 11.86 mbd last year to 12.38 mbd this year.

(2) *Supply remains ample.* Forecasting the amount of crude oil that will be produced is a much tougher endeavor. Total world supply is estimated to have increased to 97.0 mbd in Q2-2017, up from 96.1 mbd a year earlier (*Fig. 3*). Most of that supply came from the Americas, where production jumped by 0.8 mbd to 19.8 mbd (*Fig. 4*). Meanwhile, OPEC has successfully kept supply flat overall at 32.3 mbd in Q2, down ever so slightly y/y from 32.5 mbd in Q2-2016. Recently, the cartel's efforts to reduce supply were aided by the unrest in Libya that caused the nation's output to ease in August, reversing some of the increases from earlier in the year. Increased production by Nigeria has been offset by production cuts in Saudi Arabia and some other nations.

So with demand running slightly ahead of supply, the market has started to draw down some of the vast amount of oil supplies in storage. Commercial oil stockpiles were unchanged in July at just over 3 billion barrels, which was less than expected because stockpiles normally increase this time of year, a 9/13 *FT* article reported. Yesterday, the Energy Information Administration reported that crude oil being held in US storage fell by 6 million barrels last week, more than expected, due to a jump in US crude exports.

(3) *Geopolitical matters can matter.* The future of oil prices will have as much to do with politics around the world as with the industry's fundamentals. A 10/3 *Business Insider* article highlighted three risky spots to watch.

In Iraq, Kurds' vote in favor of independence in a non-binding referendum has the potential to disrupt supplies. Iraq and Turkey responded to the Kurdish vote by announcing joint military drills to be held in an area of Turkey bordering the Kurdish region of Iraq. "Turkey's President Recep Tayyip Erdogan described the vote as 'unacceptable', and threatened to close his country's sole border crossing and the Iraqi Kurds' vital oil export pipeline," a 9/25 BBC article noted.

Investors should also keep an eye on the US nuclear deal with Iran, described by President Trump as "one of the worst deals ever negotiated." He has pledged to rip up the agreement and has the opportunity to do so on October 15. If he does, Congress could reinstate the sanctions that prohibited investment in Iran's oil sector and reduced demand for Iran's crude exports. The Trump administration has also warned that it could increase the economic pressure on Venezuela's government, which could make it more difficult for that country to export oil as well.

(4) *US frackers are wild card.* One of the reasons that oil prices enjoyed a nice rally in late summer was the sudden decline in the amount of drilling rigs being used domestically. The Baker Hughes land rig count peaked at 937 on August 4. It proceeded to fall for most of the next seven weeks to a low of 916 on September 22. Last week, however, the industry watcher reported that two more land rigs were put into use. That spooked investors who feared increased production by US frackers, enticed by the recent jump in crude prices (*Fig. 5*). And suddenly, the price of two-year Brent crude oil futures dropped below the spot price of Brent crude oil (*Fig. 6*).

(5) *Back to the future*. It seems to us that the true threat to the price of oil is the advent of the electric car. If consumers decide they like plugging in their automobiles, then a huge source of demand for oil will gradually disappear. Almost half of world oil was consumed by drivers in 2015, according to an International Energy Agency 2017 report.

A number of countries recently have announced aggressive sales targets for electric cars and in some cases their intention to ban gas-powered automobiles. China hopes 1.5 million electric cars will be sold annually by 2025. On Thursday, the country "said it would require foreign auto companies manufacturing in China to start making new-energy vehicles in the country by 2019," noted a 10/2 *WSJ* article.

Paris is banning the driving of cars built before 1997 and motorcycles built before 2000 within city limits during weekdays and daylight hours. The goal: to lower pollution. By 2040, France will end sales of gas-fueled vehicles. And Norway aims to sell only electric or hybrid cars by 2025. India is considering not selling petrol or diesel cars by 2030.

Some industry watchers believe the switch to electric cars will be so fast that there won't be a need to ban gas-powered cars in the future because no one will be using them. A 7/6 article in *The Guardian* reported: "Tony Seba, a Stanford University economist who has published research predicting electric cars will even more rapidly take over from conventional cars, said of France's plan: 'Banning sales of diesel and gasoline vehicles by 2040 is a bit like banning sales of horses for road transportation by 2040: there won't be any to ban.'"

The same article noted that: "Electric vehicles will make up 54% of all light-duty vehicle sales by 2040, up from the 35% share Bloomberg was forecasting just last year, according to a new report by the research group. Bloomberg said such a widespread uptake of electric vehicles would globally reduce oil demand by 8m barrels a day and increase electricity consumption by 5% to charge all the new cars."

Sector Focus: Strong Performers. As we enter the home stretch of 2017, the leading S&P 500 sectors—Technology and Health Care—remain unchanged in ytd performance rank, but some interesting reshuffling among other sectors has been happening in recent weeks. Notably, Utilities has lost momentum, having dropped now to seventh place among the 11 S&P 500 sectors from third in early September. Conversely, Financials have come back strong, moving up to fifth place from ninth in early September (*Fig. 7*).

Here's where the S&P 500 sector performance derby stands ytd through Tuesday's close: Tech (26.4%), Health Care (19.9), Materials (15.8), Industrials (13.7), S&P 500 (13.2), Financials (12.3), Consumer Discretionary (11.4), Utilities (8.8), Consumer Staples (4.3), Real Estate (4.2), Telecom Services (-7.2), and Energy (-8.7).

The Tech sector has been fueled by the rocket-like performance of the Home Entertainment Software industry, up 63.0% ytd, and the Semiconductor Equipment industry, up 58.7% (*Fig. 8*). But industries from other sectors also appear in the top performance quartile among S&P 500 industries.

For example, Consumer Discretionary members Casinos & Gaming and Hotels, Resorts & Cruise Lines are up 54.7% and 32.7% respectively ytd. Also from that sector are high-performers Auto Parts & Equipment (42.9%) and Homebuilding (41.1). Representing the Health Care sector are Health Care Technology (52.1), Life Sciences Tools & Services (40.9), Managed Health Care (29.8), and Biotechnology (28.1). Utilities have the Independent Power Producers & Energy Trading (34.6) as a top performer. And Industrials can boast about Aerospace & Defense (30.4) and Construction Machinery & Heavy Trucks (28.6) (*Table 1*).

Industries: High Flyer. We've been optimistic about the fortunes of the Aerospace and Defense industry for a while, and it hasn't disappointed. After trading sideways for much of 2014 and 2015, the industry has rocketed higher (*Fig. 9*). The industry has much to like. Revenue growth has accelerated—from a drop of 1.9% in 2016 to expected increases of 2.4% in 2017 and 4.4% in 2018. Profit margins have improved, and earnings growth has picked up too, from only 4.8% in 2016 to an expected growth rate of 8.5% this year and 9.1% in 2018 (*Fig. 10* and *Fig. 11*).

The only point of concern would be the industry's forward P/E, which has risen to 20.9 from roughly 15 a year ago (*Fig. 12*). With all the saber-rattling going on in the world (North Korea comes to mind), it's tough to imagine anything but increases in the US defense budget. However, one area that might see softness is the industry's exposure to airlines.

A slew of new, low-cost airlines has sprung up in Europe's market in recent years, and a shakeout appears underway. Earlier this week, Britain's Monarch Airlines declared bankruptcy, leaving 110,000 passengers stranded. A 10/2 *WSJ* article explained: "Monarch Airlines, owned by private-equity firm Greybull Capital LLP, was a British tourist airline that tried to remake itself as a budget carrier. Its failure comes after Italian flag carrier Alitalia and Germany's No. 2 airline by passengers, Air Berlin PLC, ran out of money this year. Strong competition from budget airlines such as Ryanair Holdings PLC, Europe's biggest airline by passengers, and rival easyJet PLC have forced down prices, crimping the prospects of carriers that can't compete on cost. These European airline failures have implications as far away as the U.S. Air Berlin, though principally a European carrier, had to close trans-Atlantic routes."

Monarch had placed orders for 32 of Boeing's new 737 Max jetliners, and its rented planes were being returned to lessors, the article reported. Boeing's shares are up 93.2% over the past year, and Monarch's 32-plane order won't break the bank at Boeing. But the change in the European airline market certainly could cause turbulence.

CALENDARS

US. Thurs: Factory Orders 1.0%, Merchandise Trade Balance -$42.5b, Jobless Claims 265k, Challenger Job-Cuts Report, Weekly Consumer Comfort Index, EIA Natural Gas Report, Powell, Harker. **Fri:** Total & Private Nonfarm Payroll Employment 100k/117k, Unemployment & Participation Rates 4.4%/62.8%, Average Workweek 34.4hrs, Average Hourly Earnings 0.3%m/m/2.6%y/y, Consumer Credit $16.0b, Wholesale Inventories 1.0%, Baker-Hughes Rig Count, Dudley, Rosengren. (Bloomberg estimates)

Global. Thurs: ECB Account of the Monetary Policy Meeting. **Fri:** German Factory Orders 0.7%m/m/4.7%y/y, Canada Employment Change & Unemployment Rate 12k/6.2%, Japan Leading & Coincident Indexes 107.2/117.5. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): Our Bull/Bear Ratio (BBR) moved further above 3.00 this week. Our BBB rose for the third week to 3.38 after falling the prior six weeks from a five-month high of 3.70 to a 10-month low of 2.33 over the period. Bullish sentiment moved further above 50, climbing to 57.5% from 47.1% three weeks ago—which was the lowest since just before the election. Roughly 70% of the recent move up in bullish sentiment came from the correction camp, which saw sentiment fall 7.2ppts over the three-week period to 25.5%. Bearish sentiment slipped for the third week to 17.0% from a post-election high of 20.2%, back within the narrow 16.5%-18.3% range shown most of this year. The AAII Ratio slipped for the second week last week, to 53.7%, after shooting up the prior two weeks from 38.5% to a 10-month high of 65.3%. Over the two-week period, bullish sentiment fell from 41.3% to 33.3%, while bearish sentiment rose from 22.0% to 28.7%.

S&P 500 Earnings, Revenues & Valuation (*link*): Last week saw S&P 500 consensus forward revenues and earnings rise to new record highs. The forward profit margin forecast edged back up w/w to a record high of 11.1% from 11.0%. The profit margin's record high is its first since September 2015 and was up from a 24-month low of 10.4% in March 2016. Forward revenue growth for the S&P 500 was steady at a 26-week high of 5.6%. That's 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 improved to an 11-week high of 11.2% from 11.1%, 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, and Tech. 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 5.2% is 0.3ppt lower and STEG of 9.9% is 1.3ppts lower. The S&P 500 ex-Energy forward profit margin was steady w/w at a record high of 11.7%, which is its first since August 2007. The index price edged down w/w, but the forward P/E of 17.7 was steady and near a nine-week high, 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 S&P 500 price-to-sales ratio was steady at a record high of 1.98, and was also at a record high of 2.04 on an ex-Energy basis. On an ex-Energy basis, the forward P/E was steady at 17.5, which is near a nine-week high and compares to 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 6/11 sectors, and forward earnings rose for 3/11. Tech and Materials had both measures improve w/w, and these four had both measures decline: Consumer Staples, Financials, Health Care, and Utilities. 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 is stabilizing now near a 10-month low, and its forward earnings is around an eight-month low. The forward P/S and P/E ratios rose w/w for 5/11 sectors: Consumer Discretionary, Energy, Financials, Industrials, and Telecom. Health Care's P/E of 16.5 and P/S of 1.76 are down from their 25-month highs in mid-September, and remain below their early 2015 highs of 17.9 and 1.88, respectively. Financials' P/E is up from 12.0 before the election to 14.2, 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 1.37 compares to a record high of 1.56 in May 2016, and its P/E of 28.9 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. The forecasted forward profit margin was steady for all 11 sectors this week. Here's how they rank based on their current 2017 forecasts: Information Technology (to 20.0% in 2017 from 19.2% in 2016), Real Estate (18.4, 25.0), Financials (15.4, 14.3), Telecom (11.3, 11.2), Utilities (11.1, 11.5), S&P 500 (10.6, 10.1), Health Care (10.5, 10.3), Materials (9.6, 9.1), Industrials (9.1, 8.8), Consumer Discretionary (7.3, 7.3), Consumer Staples (6.5, 6.4), and Energy (3.9, 1.1).

US ECONOMIC INDICATORS

ADP Employment (*link*): In September, small businesses experienced a dip in hiring as Hurricanes Harvey and Irma significantly impacted smaller retailers. Private industries added only 135,000 last month—an 11-month low—following slight downward revisions to August (to 228,000 from 237,000) and July (198,000 from 201,000) payrolls, for a net loss of 12,000. Service-providing industries (88,000) accounted for two-thirds of September's gain, though goods-producing industries (48,000) posted another strong performance, with both construction (29,000) and manufacturing (18,000) companies recording solid gains. Within service-providing, the biggest increases came from professional & tech services (40,000), health care & social assistance (28,000), and leisure & hospitality (20,000). Large companies (79,000) held the number-one slot on the leader board, posting one of their strongest gains this year, with services-providing industries adding 66,000 payrolls and goods-producing adding 13,000. Medium-sized companies remained in the number-two spot, adding 63,000 to payrolls—with a mix of 44,000 services-providing and 20,000 goods-producing. Small-business employment recorded its first decline since the end of 2013, falling 7,000, reflecting a 22,000 loss in services-providing jobs; goods-producing companies added 15,000 jobs—the most since March.

GLOBAL ECONOMIC INDICATORS

Global Non-Manufacturing PMIs (*link*): Global service-sector growth in September grew at a similar pace to August's two-year high, rounding out the best quarter in more than two years. J.P. Morgan's NM-PMI slipped from 54.1 to 54.0, with the quarterly average rising to 53.9. Last month, service-sector growth accelerated in Ireland (58.7), France (57.0), Spain (56.7), Germany (55.6), Russia (55.2), and the UK (53.6); it slowed in the US (55.3), Australia (52.1), and Japan (51.0), while Brazil's (50.7) returned to expansion after contracting the previous four months. (Note: Due to later than usual release dates, September data for India and China services were not available for inclusion in the NM-PMI number.)

US Non-Manufacturing PMI (*link*): The US service sector in September grew at its fastest pace since August 2005 according to the ISM survey and slowed slightly according to Markit's—though was still robust. ISM's NM-PMI continued to rebound from July's 11-month low of 53.9—soaring to 59.8 last month. All four components accelerated sharply over the two-month period: New orders shot up from 55.1 to 63.0, business activity from 55.9 to 61.3, and employment from 53.6 to 56.8. The move up in the suppliers' delivery index took place entirely in September, rebounding from a recent low of 50.5 in August to 58.0 last month—the best reading since November 2005. Markit's NM-PMI fell for the first time in six months to 55.3, after climbing from 52.8 in March to 56.0 in August—which was the highest reading since November 2015. According to the report, while growth slowed last month, upturns in both activity and inflows of new work were strong compared to the latest two-year average—supporting solid employment growth.

Eurozone Retail Sales (*link*): Eurozone retail sales in August posted its first back-to-back decline in seven months, after a string of increases to new record highs. Sales posted a two-month decline of 0.8%, following a 2.0% surge the previous five months. Over the two-month period, spending on automotive fuels tanked 1.8%, while spending on food drinks & tobacco dropped 0.9%; non-food products ex auto fuel fell 0.4% in August after no change in July. Data were available for thee of the Big Four economies: Sales in Germany sank 1.6% since reaching a new record high in June, while spending in France declined 0.6% after a 0.4% loss and a 0.6% gain the prior two months; Spain eked out a 0.1% gain in sales, following a 0.4% decline in July, which was the first contraction since the start of the year. The Eurozone economies posting the biggest losses were Portugal (-1.3%), Austria (-1.0), and Belgium (-0.9); the biggest increase was in Malta (1.5).

Japan Consumer Confidence (*link*): Consumer confidence in September rose more than expected, climbing to a six-month high. The consumer confidence index has posted only one decline since falling to this year's low of 42.7 in July, climbing to 43.9 last month. All four components advanced last month: Income growth (to 42.2 from 41.6), willingness to buy durable goods (43.4 from 42.8), overall livelihood (42.3 from 42.0), and employment (47.6 from 47.3). Three of the four components remain on volatile uptrends, with income growth at its highest level since May 2013; the employment measure is stalled at its recent high.

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