MORNING BRIEFING
October 10, 2017

On a Winning Streak

See the collection of the individual charts linked below.

(1) Germany and South Korea chirping a happy song. (2) South Korean exports soaring. (3) German new orders at record high. (4) Five reasons why the global economy is booming. (5) German domestic orders for consumer goods confirming that mass migration is boosting growth. (6) Go Global beating Stay Home in dollars more than in local currencies. (7) Will winning streak last for Emerging Markets?

Germany: Another Happy Canary. Germany and South Korea stand out as two countries that are especially sensitive to global trade. Last week, Debbie and I observed that South Korea's exports soared 17.1% m/m during September to a record high of $691 billion (saar) (*Fig. 1*). The data are seasonally adjusted by our data vendor, Haver Analytics. At first, our reaction was that perhaps the seasonal adjustment program has a glitch. However, the y/y growth rate in the unadjusted data was 35.0%, the fastest since January 2011 (*Fig. 2*). This strongly suggests that the pace of global economic growth may be accelerating.

Sure enough, now Germany's August data for new orders and production are corroborating this thesis:

(1) *New orders.* The German new orders index jumped 3.6% m/m during August to a record high (*Fig. 3*). Leading the way were foreign orders, which rose 4.3% m/m and 9.1% y/y—also to a record high.

Especially strong were foreign orders outside of the Eurozone. They soared 7.7% m/m and 14.2% y/y (*Fig. 4*).

(2) *Industrial production.* Also blasting off to new record highs was German industrial production during August, as Debbie discusses below. The total (excluding construction) was up 3.0% m/m and 4.7% y/y (*Fig. 5*). Manufacturing output jumped 3.2% m/m and 5.3% y/y.

The question is why now? Last Tuesday, I reviewed five explanations for the acceleration in global economic growth. In brief: (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.

The German data confirm the global boom. They also support the notion that the wave of migration that occurred into Germany during 2015 and 2016 might have boosted domestic demand. Domestic consumer goods orders jumped 5.9% m/m during August to the highest level since December 2008. Industrial production of consumer goods has been remarkably strong, with a gain of 3.8 y/y (*Fig. 6*).

Global Strategy: 'Go Global' Is Winning. Late last year, I noticed that our accounts were getting more interested in putting more of their equity weightings in foreign stocks, mostly because foreign stocks looked cheaper than US ones. Furthermore, the fundamentals seemed to be improving overseas, while US economic growth remained relatively subdued. So Joe and I warmed up to the Go Global investment style after having been quite adamantly in the Stay Home camp since early in the current bull market. Let's review some of the recent valuation metrics and performance stats:

(1) *Valuation.* At the end of September, the US MSCI stock price index stood out as the most expensive of the major equity indexes based on forward earnings: US (18.1), EMU (14.4), UK (14.3), Japan (14.3), and Emerging Markets (12.4) (*Fig. 7*). The US has been the priciest of these indexes since the start of 2014.

The US MSCI has tended to have a higher forward P/E than the All Country World P/E since the start of the available data in 2001 (*Fig. 8*). However, the current divergence is relatively large, with the former at 18.1 and the latter at 14.2.

The major EMU indexes look especially cheap relative to the US: France (14.9), EMU (14.4), Germany (13.4), Italy (13.4), and Spain (13.1) (*Fig. 9*).

Among the Emerging Markets MSCI indexes, the valuation pecking order is as follows for the major regions: Latin America (14.1), Asia (12.6), Emerging Markets (12.4), and Eastern Europe (7.6). There is a fair amount of dispersion particularly among the Emerging Markets in Asia: India (18.2), Indonesia (15.8), Taiwan (13.4), China (13.3), Korea (8.9), and Turkey (7.9) (*Fig. 10*).

Based on the fundamentals, Germany and South Korea seem especially cheap.

(2) *Performance in dollars*. So far this year, in dollars, the US MSCI has been among the underperformers: Emerging Markets (27.9% ytd), EMU (23.7), All Country (16.4), US (14.0), Japan (13.3), and UK (11.6) (*Fig. 11*).

(3) *Performance in local currency.* The ytd performance picture changes significantly in local currencies. The US has outperformed all of the major MSCI indexes with the exception of the Emerging Markets: Emerging Markets (24.0% ytd), US (14.0), All Country (13.2), EMU (11.3), Japan (9.4), and UK (5.0) (*Fig. 12*).

If there is a melt-up coming in global stock markets, Joe and I won't be surprised if it is led by the US in both dollars and local currencies. Helping the US to outperform the rest of the world would be any sign that the Trump administration might succeed in lowering the corporate tax rate and in stimulating the repatriation of overseas earnings. Then again, the rest of the world may continue to attract buyers seeking improving fundamentals and relatively low valuations.

In any case, the Emerging Markets story is looking solid. In the past, their stock markets and currencies usually plunged when the Fed was tightening US monetary policy. That's not happening this time. Could it be that they are finally actually emerging?

CALENDARS

US. Tues: NFIB Small Business Optimism Index 105.4, Kashkari, Kaplan. **Wed:** Job Openings 6.16m, MBA Mortgage Applications, Evans, FOMC Minutes. (Bloomberg estimates)

Global. Tues: Germany Trade Balance (euros) 19.6b, UK Headline & Manufacturing Industrial Production 0.9%/1.9% y/y, China New Yuan Loans 1230b, China M2 9.0% y/y, Japan Machine Tools 1.0%m/m/0.8%y/y, Annual Meetings of the IMF and the World Bank, Kuroda. **Wed:** Japan Machine

Tools. (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—climbed 1.1% during the final week of September after sinking 8.6% the prior four weeks on a hurricane-related jump in jobless claims. Before the recent downturn, the WLI had posted a seven-week surge of 5.0% to a new record high. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). Our BBB jumped 3.2%, after tumbling 13.7% the prior four weeks, as jobless claims fell to 368,250 (4-wa) from a 19-month high of 277,750 the prior week. Claims were as low as 236,750 five weeks ago, not far from late May's 235,500—which was the lowest since April 1973. The CRB raw industrial spot price index—another BBB component—is moving sideways after a slight dip. Meanwhile, the WCCI has dropped four of the past five weeks by a total of 6.9%.

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose to a yet another record high last week for all three indexes as SmallCap posted a second straight high for the first time since mid-July. 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 fell to a 24-week low of 9.4% y/y from 9.7%, 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 improved to an eight-week high of 13.9% from 13.7%, 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 dropped to a 10-month low of 8.0% from 9.3%, 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 remained strong throughout this year instead of falling. Furthermore, the growth rates for 2018 should remain strong for all three indexes if the corporate tax rate changes sooner rather than later. Here are the latest consensus earnings growth rates: LargeCap 10.8% and 11.3%, MidCap 10.4% and 14.4%, and SmallCap 4.6% and 21.5%.

S&P 500/400/600 Forward Valuation (*link*): Forward P/E ratios rose for all three indexes last week. Looking at the weekly valuation, LargeCap's forward P/E of 17.9 was the highest since March 2004. 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. SmidCap P/Es had stalled for most of 2017 following the post-election melt-up, but are rising again now. MidCap's forward P/E rose to an 11-week high of 18.2, and is higher than LargeCap's P/E again after being below during August and September for only the second time since 2009. MidCap's P/E remains below its 15-year high of 19.2 in late February and the record high of 20.6 in January 2002, but is up from a three-year low of 15.0 in January 2016. SmallCap's rose to a 10-month high of 20.2, which compares to 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, and only 0.7ppt below SmallCap's record-high P/E of 20.9 in April 2002. Prices are at record highs for all three indexes, but their "E" still remains low as analysts await the passage of legislative changes to the tax rate and its positive impact on corporate earnings. Looking at their daily forward price/sales (P/S) ratios, valuations last week were similarly higher for the three indexes: LargeCap's P/S of 2.01 was at a record high, MidCap's 1.29 is down from a record high of 1.39 in early March, and SmallCap's 1.05 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*): Q4 earnings revisions activity remains quiet as analysts await the corporate guidance that's sure to be released as Q3 results are reported. The S&P 500's Q4-2017 EPS forecast edged down 1 cent w/w to $34.97, and is down just 1.3% from $35.42 at the end of Q2. That represents a forecasted pro forma earnings gain for Q4-2017 of 12.3%, compared to Q3-2017's blended estimate/actual of 4.9%, Q2's 12.3%, and Q1's 15.3%, which was the strongest growth since Q3-2011 owing mostly to easier comps for Energy. Since the end of Q2, Q4 estimates are higher for five sectors and lower for six. Materials' Q4 forecast has risen 7.0% followed by these sectors: Real Estate (up 2.3%), Consumer Staples (1.5), Tech (0.9), and Telecom (0.4). Energy's Q4-2017 forecast has tumbled 16.2% for the worst decline, followed by Industrials (-1.8) and Consumer Discretionary (-1.4). The S&P 500's Q4-2017 forecasted earnings gain of 12.3% y/y would be its sixth straight gain after four declines. Ten of the 11 sectors are expected to record positive y/y earnings growth in Q4-2017, and four are expected to beat or match the S&P 500's forecasted y/y earnings gain of 12.3%. That's because analysts expect Energy to report another large profit jump in Q4 relative to very low earnings a year ago. That's better than Q3-2017 which has eight sectors expected to rise y/y, but down from Q2-2017 when all 11 sectors rose y/y for the first time since Q3-2011. The latest forecasted Q4-2017 earnings growth rates vs. their blended Q3-2017 growth rates: Energy (91.3% in Q4 vs. 135.8% in Q3), Materials (23.5, 4.3), Financials (15.8, -6.2), Tech (12.3, 12.2), S&P 500 (12.3, 4.9), Industrials (11.9, 5.1), Consumer Discretionary (10.1, 0.5), Consumer Staples (9.2, 3.5), Health Care (6.8, 3.7), Utilities (3.7, -2.3), Telecom (0.5, -1.3), and Real Estate (-0.2, 3.3). On an ex-Energy basis, S&P 500 earnings are expected to rise 10.7% y/y in Q4, up from 2.9% in Q3, which is the slowest growth since ex-Energy earnings rose just 2.2% in Q2-2016. That compares to gains of 9.6% in Q2 and 11.0% in Q1.

GLOBAL ECONOMIC INDICATORS

Germany Industrial Production (*link*): The German economy appears to be firing on all cylinders. Industrial production for August soared at its fastest pace in more than six years, coming on the heels of August's big 3.6% surge in manufacturing orders. Germany's headline production—which includes construction—rebounded 2.6% after a brief dip the prior two months; output is up 4.7 y/y. (Excluding construction, production rose 3.0% m/m and 4.7% y/y.) Manufacturing output jumped 3.2%—its biggest increase since March 2010—as capital (4.8%), consumer (2.1), and intermediate (1.8) goods output all increased to new record highs. Energy output advanced 1.7%, while construction output was the outlier, slipping 1.2%. The Ministry noted that industrial production has gained momentum: "The good business morale and the positive development in industrial orders point to a continuation of the solid industrial upswing." The latest M-PMI supports this optimism. Markit reports Germany's M-PMI climbed to 60.6 in September—the highest reading since April 2011—as an acceleration in production helped lift the headline index higher.

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