



MORNING BRIEFING

October 11, 2017

Blue Skies for Blue Angels

See the [collection](#) of the individual charts linked below.

(1) Is low unemployment bad for stock returns? (2) An eternal disclaimer. (3) Might booming labor market with low inflation remain bullish for stocks? (4) Guess what? Unemployment always bottoms before recessions and bear markets. (5) MAPE showing stocks still fairly valued. (6) Nirvana continues for now. (7) Blue Angels flying into the wild blue yonder.

Strategy I: Good Jobs, Bad Returns? There's a chart floating in cyberspace showing that five-year annualized returns for the S&P 500 tend to be subpar or even negative following periods when the unemployment rate is below 5.0% ([Fig. 1](#) and [Fig. 2](#)). The jobless rate has been below that level for the past 17 months since May 2016. Over the past 60 months through September, the S&P 500 has generated an average annualized gain of 14.5%. So are returns doomed to be subpar over the next five years?

Not necessarily. In the investment business, hedge clauses always include the following disclaimer: "Past performance is not a guarantee of future performance." However, just because performance was good in the past doesn't mean that future performance must be bad. Much depends on the time frame. The DJIA was around 1000 in the late 1970s. Now it is up over 22-fold. Over the past 40 years, stocks have been great performers, though the disclaimer was relevant a few times along the way over five-year periods.

The wannabe rule of thumb that a jobless rate of less than 5% is bad for stock returns implicitly assumes that low unemployment leads to high inflation and interest rates. In the past, the booms inevitably led to busts, which have always been bad for stocks. So five-year periods following cyclically low unemployment were bound to include a recession and a bear market, which is why returns had been bad after a period when the labor market is good.

However, we have to consider the possibility that a tight labor market might not be as inflationary as it had been in the past. It hasn't been so far for numerous reasons that Debbie, Melissa, and I have discussed for quite some time. They include globalization, technological innovation, and aging demographics. If there's no boom, there isn't likely to be a bust. Consider the following:

(1) *Unemployment cycle*. Amazingly, the cyclical low in the jobless rate always occurs right before the start of recessions ([Fig. 3](#)). We are just testing you to see if you are paying attention: Of course, that's a tautology. There have been plenty of times when the unemployment rate has dropped below the previous cyclical low and continued to fall lower as stock prices continued to gain.

Nevertheless, it is true that bear markets begin at about the same time as the unemployment rate bottoms ([Fig. 4](#)). So calling the bottom in the unemployment rate would be a good call. Call us when you are sure it has bottomed. We think it could go lower.

(2) *Misery Index*. A related rule of thumb is based on the Misery Index, which is the sum of the unemployment rate and the CPI inflation rate on a y/y basis ([Fig. 5](#)). It seems to give a bit more warning

ahead of bear markets. That's because in the past, cyclical lows in the unemployment rate were increasingly offset by rising inflation. The Misery Index has had a tendency to peak during recessions as both unemployment and inflation peaked.

However, none of the above is science. Tell us when the next recession starts using the jobless rate, the Misery Index, or any other forecasting tool, and we'll tell you when the next bear market will be underway.

(3) *Misery-adjusted forward P/E*. While we are on the subject, we've previously concocted a misery-adjusted forward P/E (MAPE) by simply summing the S&P 500 forward P/E and the Misery Index ([Fig. 6](#)). Its average value since September 1978 has been 23.9. It was 24.0 during August, suggesting that the market is fairly valued. Of course, there are plenty of other valuation metrics—such as traditional P/Es, CAPEs, and Buffett-style ratios—showing that stocks are extremely overvalued. We've recently favored the S&P 500 real earnings yield, which agrees with the fair-value assessment of our MAPE.

Strategy II: Wild Blue Yonder. While some measures of stock market valuations are flying into the wild blue yonder, so are revenues and earnings. For now, it still looks like a Nirvana scenario for stock investors. That should remain the case as long as valuations don't continue to outpace earnings. Valuations recently have been outpacing earnings, however, which is why Joe and I raised our subjective probability of a Melt-Up scenario from 50% to 55% on Monday. The reason we gave was that a melt-up seemed to be unfolding: "melting up seems to be what stocks continue to do."

We also raised the odds of a Meltdown scenario from 20% to 25%, simply because melt-ups tend to be followed by meltdowns in the stock market. By default, that forced us to lower the odds of Nirvana from 30% to 20%.

Right now, Nirvana is where we are in real time. Looking ahead, too much of a good thing may be too much of a good thing. We much prefer Nirvana to a Melt-Up/Meltdown, and we hope that we can raise the odds of Nirvana soon. Either way, the odds of stock prices continuing to rise either at a leisurely slow pace or at an irrationally fast pace add up to 75% currently, in our estimation. Now consider the following:

(1) *Forward revenues*. In recent weeks through the end of September, forward revenues for the S&P 500/400/600 all have been rising in record-high territory ([Fig. 7](#)). Just as impressive is that revenue estimates for this year and next year have remained steady for the S&P 500 and have been rising for the S&P 400/600.

Currently, S&P 500 revenues are expected to rise 5.7% this year and 5.0% next. Those solid growth rates undoubtedly reflect the improving outlook for the global economy, as we have been discussing since late last year. The IMF, which has been forced to lower its estimates for global growth during most of the years since the 2008 financial crisis, has been raising its numbers.

Yesterday, the IMF raised its estimates for global economic growth in 2017 and 2018, citing stronger expansion in the first half of the year in the Eurozone, Japan, and some emerging markets. Globally, the IMF upped its growth forecasts to 3.6% in 2017 and 3.7% in 2018, both 0.1% higher than projections in July. Global growth in 2016 was 3.2%.

(2) *Forward earnings*. As Joe reported yesterday, the forward earnings of the S&P 500/400/600 all rose to record highs during the first week of October ([Fig. 8](#)). On the other hand, industry analysts are doing what they typically do at the start of earnings seasons; they lower their estimates ([Fig. 9](#)). As a result, they are estimating a weak 4.0% y/y increase for Q3-2017 ([Fig. 10](#)). Joe and I expect that this will turn

out to be another setup for the usual earnings hook as reported earnings beat reduced expectations. Gee, what a surprise!

(3) *Blue Angels*. Our Blue Angels analysis of the S&P 500/400/600 shows that all three indexes are flying high along with both forward earnings and forward P/Es ([Fig. 11](#)).

CALENDARS

US. Wed: Job Openings 6.16m, MBA Mortgage Applications, Evans, FOMC Minutes. **Thurs:** Jobless Claims 251k, Headline, Core, and Core Less Trade Services PPI-FD 0.4%/0.2%/0.2%, Weekly Consumer Comfort Index, Treasury Budget, EIA Natural Gas Report, EIA Petroleum Status Report, Powell. (Bloomberg estimates)

Global. Wed: Japan Machine Tools. **Thurs:** Eurozone Industrial Production 0.6%_{m/m}/2.6%_{y/y}, BOE Credit Conditions & Bank Liabilities Surveys, Draghi. (DailyFX estimates)

STRATEGY INDICATORS

S&P/Russell LargeCaps & SMidCaps ([link](#)): These LargeCap price indexes are back at record highs, but the SMidCaps have pulled back slightly from their late-July records. Since the election, the SmallCap market-cap indexes have outperformed LargeCaps and MidCaps. On a ytd basis, the LargeCaps are easily beating the SMidCaps, but the gap is narrowing. Here's the ytd score through Monday's close and their percentage changes since Election Day: S&P LargeCap 500 (13.7% ytd, 18.9% since the election), Russell LargeCap 1000 (13.6, 19.1), Russell MidCap (11.3, 17.7), Russell SmallCap (10.8, 25.8), S&P MidCap 400 (9.2, 19.8), and S&P SmallCap 600 (8.7, 25.4). 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 Growth vs. Value ([link](#)): The S&P 500 Growth index is up 19.3% ytd, well ahead of the 7.3% gain for its Value counterpart. Growth had trailed Value in the four months following the election. Now, Growth's 21.5% gain since the election is leading the 15.4% increase for Value. During 2016, the S&P 500 Growth index underperformed its Value counterpart by a wide margin, rising just 5.1% vs Value's 14.3% gain. Growth is expected to deliver higher forward revenue growth (STRG), but lower forward earnings growth (STEG), than Value over the next 12 months: 7.9% STRG and 11.4% STEG for Growth, respectively, vs 4.2% and 11.0% for Value. Growth's P/E of 20.3 is near the highest since February 2004, while Value's 15.6 is down from early March's 14-year high of 16.2. Regarding NERI, Growth's was positive in September for a fifth month as it dropped to 4.8% from 5.5%, but remains close to June's six-year high of 8.0%; that compares to a five-year low of -16.2% in April 2015. Value's NERI was also positive in September for a fifth

month, following 33 months of negative readings, but dropped to 0.1% from 1.4% and is down from June's six-year high of 4.7%; that compares to a five-year low of -20.3% in April 2015.

US ECONOMIC INDICATORS

NFIB Small Business Optimism Index ([link](#)): September's Small Business Optimism Index (SBOI) tumbled 2.3 points to 103.0 after climbing the prior two months from 103.6 to 105.3—which was just shy of January's cyclical high of 105.9. According to NFIB's president and CEO, "The temptation is to blame the decline on the hurricanes in Texas and Florida, but that is not consistent with our data. Small business owners across the country were measurably less enthusiastic last month." Six of the 10 components fell in September, three improved, while earnings trends was unchanged. Both sales expectations (to 15% from 27%) and now is a good time to expand (17 from 27) posted double-digit declines, followed by sizable losses in better business conditions (31 from 37) and capital expenditure plans (27 from 32); current job openings (30 from 31) and expected credit conditions (-4 from -3) edged lower. The one bright spot in the report was a five-point increase in inventory plans (7 from 2); the move up in both current inventory (-3 from -5) and plans to increase employment (19 from 18) were small. (NFIB noted that the news about tax reform came out too late to have a significant impact on expectations; the October survey will reflect whatever impact that debate will have.)

GLOBAL ECONOMIC INDICATORS

UK Industrial Production ([link](#)): UK industrial output in August increased for the fifth month, up 0.2% m/m and 1.3% over the period—after sliding 1.8% the first three months of the year. August's increase was weighed down by a 2.0% drop in mining & quarrying output, but manufacturing output advanced for the fourth month, by 0.4% m/m and 1.2% over the period, to its best level so far this year. August's gain in manufacturing was fairly widespread, with consumer durable (3.3%), consumer nondurable (0.7), and intermediate (0.1) goods output all in the black; capital goods production slipped 0.1% after a three-month gain of 2.8% to a new cyclical high. Looking ahead, Markit reports that the UK's manufacturing sector continued to expand at a fast pace in September. Its M-PMI edged down from 56.7 to 55.9—which is well above its long-run average of 51.7. The report noted that new export business remained among the best registered over the past six and a half years.

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