MORNING BRIEFING
October 12, 2017

2018 Is Coming

See the collection of the individual charts linked below.

(1) Q3 earnings cut by hurricanes and by analysts doing what comes naturally. (2) Industry analysts expecting solid revenues growth in 2018, with higher profit margins also boosting earnings. (3) Catalonians want to secede from Spain. (4) Companies ready to say *adios*. (5) Spanish economic indicators are *muy bueno* across the board. (6) Spanish stocks remain relatively cheap despite separatist issue.

Strategy: Another Happy Year Ahead? On July 1, analysts thought S&P 500 earnings would rise by 8.6% y/y during Q3. Now they expect earnings to increase by only 4.3%. Blame it on the terrible hurricane season? Some insurance, energy, and transportation companies were hit hard. Then again, cutting earnings estimates is just what analysts usually do prior to earnings seasons. Two sectors have weighed most heavily on the results: Financials and Energy. On July 1, the S&P 500 Financial Services sector's Q3 earnings were forecast to rise by 6.4%, and now they are expected to fall 9.1%. Likewise, S&P 500 Energy sector earnings are expected to jump 140.4%, down from the July 1 estimate of 186.5%.

Despite the gloomier outlook for Q3, the S&P 500's streak of new record highs has continued in October, implying that Q3 earnings results, whatever they might be, are yesterday's news, as long as they don't significantly alter expectations for next year. That's even truer for Q4 results since we won't have them until early next year. Investors are clearly looking ahead to 2018, when bottom-up analysts are calling for strong revenue growth, margin improvement, and even stronger earnings growth. Here's a look at what all the excitement is about:

(1) *Solid sales*. What instantly jumps out about 2018 is the strength of expected S&P 500 companies' sales. They are forecasted to rise 5.0% next year, after climbing an estimated 5.8% this year. Results are strong even if the contribution from the Energy or Financials sectors is backed out, 5.0% and 5.2%. The strength is also broad-based: Seven of 11 S&P 500 sectors are expected to have revenue growth north of 4%.

Here's how analysts see revenue growing in 2018 for the S&P 500 sectors: Tech (8.9%), Materials (6.4), Energy (5.4), Consumer Discretionary (5.4), Health Care (5.3), Real Estate (5.1), S&P 500 (5.0), Industrials (4.8), Consumer Staples (3.4), Financials (3.4), Utilities (2.4), and Telecom Services (0.6). These forecasts have been inching up over the past month. The overall S&P 500 sales estimate has increased by 0.1% over the past month, and estimates for nine of the 11 sectors' revenue growth have increased or stayed flat. The exceptions: Financials, for which 2018 revenue estimates have declined by 0.1%, and Energy, for which they've declined by 0.3%.

(2) *Good earnings.* Solid sales growth is expected to result in even stronger earnings growth next year—if analysts are on target. They expect the S&P 500 to generate 11.5% earnings growth in 2018, a nice improvement from the 10.3% growth forecast for this year. Again, 2018's results are strong even if

the Energy or Financials sectors are excluded, 10.7% and 11.0%.

As is often the case, the average masks a wide range of outcomes. The S&P 500 Energy sector is expected to produce 35.7% earnings growth in 2018, while analysts forecast a 1.5% drop in earnings for the Real Estate sector. Here's the performance derby for the S&P 500 sectors' 2018 earnings: Energy (35.7%), Materials (18.0), Financials (13.6), Tech (13.1), S&P 500 (11.5), Industrials (10.8), Consumer Discretionary (10.4), Health Care (8.4), Consumer Staples (7.8), Utilities (5.0), Telecom Services (1.7), and Real Estate (-1.5).

The S&P 500 earnings estimate for 2018 has been trimmed by 0.1% over the past month. Minor downward revisions occurred in Financials, Telecom Services, and Utilities. More substantial trimming occurred in the estimates for Industrials' earnings (-1.1%), Materials (-0.9), Energy (-0.8), and Real Estate (-0.8). Those downward revisions were almost entirely offset by the 1.1% upward revision in the Tech sector. Despite the trimming, industries in the Energy sector are forecasted to generate the strongest earnings among all of the S&P 500 industries we track. Top industry earnings in 2018 are expected to come from Oil & Gas Exploration & Production (382.8%) and Oil & Gas Equipment & Services (69.9).

The Materials sector is also home to some of the industries with the fastest-growing earnings next year. For example, the Copper industry, with 48.7% estimated earnings growth in 2018, and Construction Materials (37.1%) are among the top eight S&P 500 industries ranked by projected earnings growth next year (*Table 1*).

(3) *Record margins.* Investors looking for a reason to be cautious on the stock market should consider that S&P 500 earnings estimates for 2018 assume that operating margins will continue to expand from current record levels. Analysts' consensus earnings and revenue estimates imply that the S&P 500 operating profit margin will improve from 10.1% in 2016 and an estimated 10.5% this year to 11.2% in 2018 (*Fig. 1*).

The Tech sector pulls up the S&P 500's operating profit market average, with a 20.8% operating margin forecasted for 2018 (*Fig. 2*). However, the Tech sector's margin is currently in record territory, and the 2018 earnings forecasts depends on margin improvement continuing, up from an expected 20.0% this year and 19.2% in 2016.

Optimists can counter that there's room for margin improvement in Financials and Energy. Analysts forecast that the Financial sector's margin will widen to 16.6% in 2018, up from 15.1% this year and 14.3% in 2016 (*Fig. 3*). That improvement seems plausible given that it's still off from the record-high forward profit margin of 17.8% posted in August 2007. The Energy sector also may help bolster the S&P 500's margins in the future. The downtrodden sector's operating profit margin is expected to recover to 5.0% in 2018, up from 3.9% this year and 1.1% in 2016; however it's far from the double-digit levels enjoyed earlier in the decade (*Fig. 4*).

Here's how the estimated 2018 operating profit margins stack up for the S&P 500's 11 sectors: Tech (20.8%), Real Estate (17.1), Financials (16.6), Telecom Services (11.4), Utilities (11.4), S&P 500 (11.2), Health Care (10.8), Materials (10.7), Industrials (9.6), Consumer Discretionary (7.7), Consumer Staples (6.8), and Energy (5.0) (*Table 2*).

Spain I: Breaking Up Is Hard To Do. Defusing a tense showdown Tuesday between Catalan separatists and Spain's central government in Madrid, Catalonia's President Carles Puigdemont softened his stance and pulled back from declaring independence, Reuters reported in a 10/10 story. Instead, the separatist leader said he would suspend the results of the 10/1 referendum on independence—known as “1-O”—and pursue talks with the central government that would include representatives from the European Union.

The move came two days after hundreds of thousands of anti-secessionists demonstrated in Barcelona on Sunday, a 10/8 article in the *NYT* reported. In addition, a host of companies prepared to move their legal domains out of the region, one of Spain’s most prosperous, representing 20% of the country’s GDP and 25% of exports, a 10/9 Bloomberg piece explained. Among others, CaixaBank SA, the region’s largest lender and the country’s third largest in terms of global assets, said it would move its base beyond Catalonia to Valencia. Banco Sabadell SA, the nation’s fifth-largest bank based on assets, is moving to Alicante. The only remaining Catalan company in the benchmark IBEX 35 index is the drug maker Grifols.

Moreover, the European Commission announced that a separate Catalan government would find itself outside the European Union and would have to reapply for membership, creating onerous trade barriers. France, too, said it wouldn’t recognize Catalonia separately from Spain, according to a 10/9 *Guardian* article. Barcelona is the preferred Spanish city for foreign companies, with one-third of them choosing the regional capital for their base of operations.

Spain’s Prime Minister Mariano Rajoy took a hard line in attempting to quash the separatist movement, noted a 10/9 piece by *Independent.* After declaring the referendum on the region’s independence illegal, his government took control of the region’s finances and sent thousands of military police to Barcelona to prevent voting, an action that erupted in violence as police fired rubber bullets at the crowds and beat voters with batons. Rajoy then upped the ante by threatening to take control of the autonomous region, an extreme action reminiscent of the days before democracy when the military dictator Francisco Franco ruled. On Wednesday, he moved forward with his threat by initiating a request to invoke Article 155 of the Constitution, the tool that would give him those broad powers, the *NYT* reported in a 10/11story.

The political uncertainty that has escalated in the past month pressured financial markets and threatened to undercut Spain’s powerful economic momentum. Investor worries drove the MSCI Spain Share Price Index down 2.6% in dollars this month through Tuesday’s close, bringing its ytd gain to 23.9%. That compares with the 29.3% advance the index had delivered this year through August 1, as cited in our 8/3 *Morning Briefing*, “Sangria Summer.”

In the days leading up to the 10/1 referendum, yields on Catalan bonds rose to their highest levels of the year on concerns of redenomination. The spread between Spanish and German 10-year notes widened following the referendum but tightened amid this week’s developments, with yields hitting their lowest level since before the vote (*Fig. 5*).

Spain II: United We Stand. Manufacturing and services data released in the days following the referendum revealed an economy that continues to strengthen despite the unsettled politics (*Fig. 6*). Consider the latest good news on the Spanish economy:

(1) *Services PMI.* The seasonally adjusted Business Activity Index rose to 56.7 in September from 56.0 in August, according to a 10/4 report by data tracker IHS Markit, noting the “sharp and accelerated increase.” The number confounded economists who had been expecting a slowdown to 55.5. It was the 47th straight month of increased business activity at Spanish service companies, reflecting better market conditions and rising numbers of customers. Activity was broad-based, but the Post & Telecommunications sector saw the fastest growth as well as the biggest increase in new business.

(2) *New orders.* New orders in September expanded across the services sector at the fastest rate since

August 2015. It was the 50th consecutive month that the services sector saw new orders increase. Stronger client demand led to higher output prices, with prices rising at one of the fastest rates in a decade. Price increases occurred in all sectors, led by Hotels & Restaurants.

(3) *Staffing.* A jump in workloads led to more hiring in September, with the Financial Intermediation sector logging the sharpest rise in employment. As a result, input prices rose, though at a rate that was the weakest in a year. A 10/6 country focus by the International Monetary Fund notes that one-quarter of all jobs created in the Eurozone over the past year were in Spain, mainly in the services sector, in which 79% of all Spaniards work.

(4) *Manufacturing.* Spain's manufacturing purchase managers index rose to 54.3 in September from 52.4 the previous month, on stronger demand and new export business as new orders from overseas jumped sharply, IHS Markit revealed in a 10/2 report. Production increased for the 46th straight month, with the intermediate goods sector marking the fastest growth. New orders, output, and employment increased sharply during the month.

(5) *Supply chains.* Raw materials shortages continue to extend delivery times and contribute to price inflation. The pace of inflation growth last month was the fastest since April, with steel prices particularly strong.

(6) *Business Climate.* Confidence soared among Spanish businesses in September, supporting sentiment expressed to IHS Markit that conditions will further strengthen in the coming year (*Fig. 7*).

With a P/E of 13.1, Spain's MSCI index continues to represent value as earnings growth now stands at (recently revised upward) 12.3% for 2017 and 9.3% for 2018 (*Fig. 8*). In contrast, earnings for Europe MSCI companies are estimated at 12.7% for this year and 8.5% for 2018, and the index is trading at a 14.5 P/E.

CALENDARS

US. 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. **Fri:** Retail Sales Total, Ex Autos, Ex Autos & Gas, Control Group 1.8%/0.8%/0.4%/0.2%, Business Inventories 0.7%, Headline & Core CPI 2.3%/1.8% y/y, Consumer Sentiment Index 95.4, Baker Hughes Rig Count, Yellen, Evans, Kaplan, Powell. (Bloomberg estimates)

Global. Thurs: Eurozone Industrial Production 0.6%m/m/2.6%y/y, BOE Credit Conditions & Bank Liabilities Surveys, Draghi**. Fri:** Germany CPI 0.1%m/m/1.8%y/y, China Trade Balance $38.1b. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): Our Bull/Bear Ratio (BBR) reached 4.00 this week—its highest reading since late April 2015. It was the fourth straight increase 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 climbed to 60.4% from 47.1% four weeks ago—which was the lowest since just before the election. Just over 60% of the recent move up in bullish sentiment came from the correction camp, which saw sentiment fall 8.2ppts over the four-week period to 24.5%. Bearish sentiment slipped for the fourth week to 15.1% from a post-election high of 20.2%, falling below the narrow 16.5%-18.3% range shown most of this year. The AAII Ratio slipped for the third week last week from a 10-month high of 65.3% to 52.0%. Over the three-week period, bullish sentiment fell from 41.3% to 35.6%, while bearish sentiment rose from

22.0% to 32.8%.

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 was steady at a record high of 11.1%, which is its first since September 2015 and up from a 24-month low of 10.4% in March 2016. However, forward revenue growth for the S&P 500 ticked down to 5.3% from 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 a 13-week high of 11.3% from 11.2%, 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 5.1% is 0.2ppt lower and STEG of 10.2% is 0.9ppts 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 forward P/E rose to 18.0 , which matches late July's 13-year high and compares to a 15-month low of 14.9 in January 2016. The S&P 500 price-to-sales ratio rose to a record high of 1.99 from 1.98, and was also at a record high of 2.06 on an ex-Energy basis. On an ex-Energy basis, the forward P/E of 17.6 is the highest since February 2004.

S&P 500 Sectors Earnings, Revenues & Valuation (*link*): Consensus forward revenue forecasts rose last week for all 11 sectors, and forward earnings rose for all but Real Estate. 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 and earnings are ticking higher now, but remain near their lowest levels since the spring of 2017. The forward P/S and P/E ratios rose w/w for 9/11 sectors (all but Consumer Discretionary and Consumer Staples). Health Care's P/E of 16.7 and P/S of 1.79 are down a tick 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 14.3, 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 1.36 compares to a record high of 1.56 in May 2016, and its P/E of 28.2 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 (18.3, 25.0), Financials (15.1, 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 (9.7, 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

JOLTS (*link*): Job openings fell for only the second time this year, slipping 58,000 in August to 6.082 million, after rising six of the prior seven months by 601,000 to a record-high 6.140 million. Meanwhile, hirings slipped 91,000 to 5.430 million after reaching 5.521 million in July, which was its best reading since November 2006. Separations fell 134,000 to 5.228 million from 5.362 million in July—which was its highest since May 2006. The latest hirings and separations data yielded an employment advance of 202,000 for August, 33,000 above August's payroll gain of 169,000—coming in above payroll employment for the fifth time in seven months. August's job-opening rate (4.3%) held at its record high, while the total hires rate (4.1%) edged down from its cyclical high of 4.2%; the quit rate (2.4) held just below May's cyclical high of 2.5% for the third month. The ratio of unemployed workers per job opening (1.17) edged up from July's cyclical low of 1.14—which was only slightly above January 2001's record low of 1.12; it peaked at 6.65 during July 2009.

Contact us by email or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor & Webmaster, 570-775-6823