MORNING BRIEFING
October 25, 2017

Fearless

See the collection of the individual charts linked below.

(1) Where have all the black swans gone? (2) Trump's white swan. (3) Hurricanes depressed Q3 results. (4) Q4 earnings estimates showing double-digit growth. (5) Analysts upbeat about 2018 and 2019 revenues and earnings. (6) On the lookout for gray swans. (7) Reprise of 1987? (8) Fed regime change. (9) When all QEs terminate, will stocks fall? (10) Black swans sighted in the South China Sea.

Strategy I: White Swans. Pete Seeger's song asks, "Where have all the flowers gone?" Today, the question is, "Where have all the black swans gone?" Is it really possible that we have nothing to fear but fear itself? It's not that hard to come up with more substantial fears. For example, as I observed yesterday, many of our accounts are asking me, "Won't the stock market take a dive if the Republicans fail to pass tax reform including tax cuts?" My answer, "What if they succeed in doing so?" That white swan seems to be driving stock prices to new record highs since the Trump administration presented its 9/27 *Unified Framework for Fixing Our Broken Tax Code*.

Another white swan for stock prices is earnings. Let's review the latest data:

(1) *Q3*. The Q3 earnings season is showing that the blended estimated/actual earnings for S&P 500/400/600 are down sharply through the 10/19 week (*Fig. 1*). Some of the weakness reflects the hit from hurricanes Harvey and Irma. The traditional upside hook is showing up in the S&P 500's Q3 earnings series. The stock market is obviously ignoring that y/y earnings growth rates are down for S&P 500 (from 10.0% during Q2 to 3.5% during Q1), S&P 400 (12.3% to 3.4%), and S&P 600 (6.1% to 0.9%) (*Fig. 2*).

(2) *Q4.* Analysts must believe that the Q3 weakness is temporary, because their earnings estimates for Q4 have been remarkably stable since the start of the year. They are expecting Q4 rebounds in earnings growth rates back into the double digits for the S&P 500 (12.0%), S&P 400 (13.0), and S&P 600 (18.1).

(3) *2018.* Also holding up remarkably well are analysts' consensus earnings expectations for the three market-cap categories in 2018 (*Fig. 3*). They are currently predicting solid growth rates for next year for the S&P 500 (11.6%), S&P 400 (15.2%), and S&P 600 (22.2%).

(4) *2019.* Joe and I are now starting to track weekly consensus expectations for 2019 earnings. Analysts currently estimate that S&P 500 earnings will rise from $130.70 this year to $145.91 next year and $159.30 in 2019. The 2019 growth rates for the S&P 500/400/600 are 9.2%, 3.9%, and 5.7%.

(5) *Forward earnings.* Since they are time-weighted averages, forward earnings of the three S&P 500 stock market indexes are rapidly converging toward their 2018 consensus estimates. Next year, they will increasingly give more weight to their estimates for 2019 and less to those for 2018. In other words, company results being reported now for Q3 and to be reported in January for Q4 are mostly irrelevant to stock market investors at this point, except in cases suggesting significantly altered earnings outlooks for 2018 and 2019.

(6) *Forward revenues.* Driving earnings estimates higher are solid projected growth rates in revenues (*Fig. 4*). For 2018, they are estimating 5.1%, 5.0%, and 5.3% for the S&P 500/400/600. For 2019, their estimate revenues growth rates are 4.9%, 3.9%, and 4.3%. The march to record highs of the S&P 500 forward revenues since early this year has been particularly impressive.

Strategy II: Gray Swans. With so many white swans swimming in the stock market, it's hard to see any black ones. Our worst-case scenarios currently are more like gray swans:

(1) *1987 all over again.* The stock market melts up through early next year. Then something bad happens, which isn't so bad but is bad enough to cause an ETF-led flash crash. Neither the bad event nor the crash are wicked enough to cause a recession. So it would be reminiscent of 1987, when the S&P 500 plunged 20.5% on Black Monday, October 19. The closing price of that day turned out to be a great buying opportunity. The S&P 500 retested this low on December 4 before starting a new bull market. The bad event in this scenario might be the failure of the Republicans to achieve their tax reform agenda.

(2) *New Fed sheriffs.* Another event that might trigger a meltdown, or cap a meltup, might be a more hawkish Fed. Under the leadership of newly appointed governors to replace Fed Chair Janet Yellen and Fed Vice Chair Stanley Fischer, the Fed might be more inclined to see a stock market meltup as a potentially worrisome bubble. If so, the FOMC might be more willing to employ either monetary policy and/or so-called macroprudential policies to take some air out of the bubble.

(3) *QE termination.* Another gray swan might be the termination of QE programs by the major central banks. The perma-bears (remember them?) growled that the current bull market was driven mostly by the Fed's QE programs. They showed a chart with the S&P 500 compared to the balance-sheet assets of the Fed (*Fig. 5*). The two series were highly correlated until the Fed terminated QE at the end of October 2014. Since then, the Fed's assets have been flat around $4.3 trillion, while the S&P 500 is up 27.1%!

This month, the Fed started to let its balance sheet shrink as its bonds mature. Yet there's no fear showing in the stock market, or even the bond market for that matter. Perhaps the gray swan will make an appearance when the European Central Bank (ECB) and the Bank of Japan (BOJ) announce that they are terminating their QE programs. The S&P 500 may be hooked on the combined QE programs of the Fed, the ECB, and the BOJ (*Fig. 6*).

(4) *Little Kim.* Perhaps something bad will soon happen between the United States and North Korea. This past weekend, Japanese Prime Minister Shinzo Abe was re-elected with a decisive win. He is one of President Donald Trump's strongest allies in Asia as both Washington and Tokyo grapple with how to handle Pyongyang. CNN reported: "Abe, a conservative hawk, has long been a supporter of Trump's more aggressive North Korea policy, which has coincided with his attempts to rewrite Japan's post-war pacifist constitution.

"Following Sunday's vote, Japanese Defense Minister Itsunori Onodera warned the threat from North Korea—which has repeatedly fired missiles over Japan in recent months—had reached an 'unprecedented, critical and imminent' level."

The question is, "Why don't the Chinese remove Kim Jong Un, the belligerent nuke-obsessed leader of North Korea?" Thanks to him, Abe was basically given a mandate to upgrade Japan's military capabilities, not a welcome development in Beijing. The Chinese know where all of North Korea's nukes are located since they trained all of the country's rocket scientists. They can always de-Kim and de-nuke North Korea. So what are they waiting for?

They may be hoping to use their obvious leverage to change North Korea's regime to get recognition of their sovereignty over the South China Sea resulting from their man-made islands. It's a dangerous game, but it isn't likely to end with a military confrontation. That seems to be the widespread assumption among stock investors. I agree. However, that elusive black swan we've been looking out for just could be swimming in the South China Sea.

CALENDARS

US. **Wed:** Durable Goods Orders Total, Ex Transportation, and Core Capital Goods 1.0%/0.5%/0.5%, New Home Sales 555k, FHFA Price Index 0.4%, MBA Mortgage Applications, EIA Petroleum Status Report. **Thurs:** Advance Merchandise Trade Balance -$69.3b, Jobless Claims 235k, Kansas City Fed Manufacturing Index, Pending Home Sales 0.4%, Weekly Consumer Comfort Index, EIA Natural Gas Report, Kashkari. (*Wall Street Journal* estimates)

Global. **Wed:** Germany Ifo Business Climate, Current Assessment, and Expectations Indexes 115.0/123.5/107.3, UK GDP 0.3%q/q/1.5%y/y, Australia CPI 2.0% y/y, BOC Rate Decision 1.00%. **Thurs:** Germany Gfk Consumer Confidence 10.8, Japan CPI Headline, Core, and Core-Core 0.7%/0.7%/0.2% y/y, ECB Rate Decision 0.00%, ECB Marginal Lending Facility & Deposit Facility Rates 0.25%/-0.40%. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Sectors Net Earnings Revisions (*link*): The S&P 500's NERI was positive for a sixth straight month in October, its longest positive streak since the 26-month string ending August 2011. NERI improved to 3.6% from 3.1% in September, but is down from a six-year high of 6.2% in June. NERI improved m/m for 5/11 sectors in October and was positive for 6/11 sectors (compared to three improving and five positive in September). Tech topped all sectors in October for a third month in a row and has the longest positive NERI streak of 15 months, the best since August 2011 when its 28-month streak ended. Financials has the next best positive streak at 13 months, followed by Health Care (6). Energy has the worst recently, with seven straight months of negative NERIs, followed by Consumer Discretionary (3). Telecom turned positive for the first time in 18 months. Here are the sectors' October NERIs compared with their September readings, ranked in descending order: Tech (15.9% in October [81-month high], up from 14.8% in September), Financials (6.5, 8.2), Health Care (6.4, 9.2), S&P 500 (3.6, 3.1), Materials (2.5, -0.8), Telecom (2.1 [18-month high], -0.9), Consumer Staples (1.3 [15-month high], -1.3), Industrials (-0.4, 5.4), Utilities (-0.6, 1.0), Consumer Discretionary (-1.2, -0.4), Energy (-4.4, -22.2), and Real Estate (-5.2 -1.1).

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. Forward revenue growth for the S&P 500 ticked up to 5.5% from 5.4%. 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 was steady at a nine-month high of 11.5% from 11.3%. That compares to January's 11.7%, which was the highest since October 2011 and 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 only 0.3ppts lower and STEG of 10.4% 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 was steady at 18.1, which is the highest since February 2004 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 2.01, and was also steady at a record high of 2.07 on an ex-Energy basis. On an ex-Energy basis, the forward P/E of 17.7 remains the highest since February 2004.

S&P 500 Sectors Earnings, Revenues & Valuation (*link*): Consensus forward revenue forecasts rose last week for 8/11 sectors, and forward earnings rose for 9/11. Industrials was the only sector to have both measures drop 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 and earnings are ticking higher now, but remain near their lowest levels since the spring of 2017. Health Care's P/E of 16.8 and P/S of 1.79 are down a tad 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 14.4, 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 1.34 compares to a record high of 1.56 in May 2016, and its P/E of 27.1 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 typically improves as the year progresses when gains on property sales are included in the forecasts. In the latest week, the forecasted forward profit margin edged up 0.1ppt for Energy and ticked down the same amount for Financials. 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 (15.0, 14.3), Telecom (11.7, 11.6), Utilities (11.2, 11.5), S&P 500 (10.5, 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 (4.0, 1.1).

S&P 500 Q3 Earnings Season Monitor (*link*): With 24% of S&P 500 companies finished reporting Q3-2017 earnings and revenue results through midday Tuesday, their surprise and y/y growth results are mixed compared to the same point during the Q2 earnings season, but more companies are reporting a positive surprise. Of the 120 companies in the S&P 500 that have reported, 74% exceeded industry analysts' earnings estimates, by an average of 2.7%; they have averaged a y/y earnings gain of 10.1%. At the same point during the Q2-2017 reporting period, a lower percentage of S&P 500 companies (73%) had beaten consensus earnings estimates by a higher 6.6%, and earnings were up a higher 16.0% y/y. On the revenue side, 72% beat sales estimates so far, with results coming in 1.2% above forecast and 5.5% higher than a year earlier. At this point in the Q2 season, a similar 72% had exceeded revenue forecasts by a slightly higher 1.3%, and sales rose a lower 3.8% y/y. Q3 earnings results are higher for 78% of companies, vs 67% at the same point in Q2, and revenues also are higher for 84%, vs 81% a quarter ago. Although these figures will change markedly as more Q3-2017 results are reported in the coming weeks, particularly for the insurers, the early results are encouraging. Q3-2017 should mark the fifth straight quarter of positive y/y earnings growth despite the negative impact of the three hurricanes. However, growth is likely to fall back into the low single digits following double-digit percentage growth in Q1 and Q2, which was the first double-digit growth seen since Q3-2011.

US ECONOMIC INDICATORS

Regional M-PMIs (*link*): Three Fed districts so far have reported on manufacturing activity for this month—New York, Philadelphia, and Richmond—and they show growth in the sector accelerated for the third straight month at a robust pace. We average the composite, orders, and employment measures as data become available. The composite index rebounded from 14.4 in July to 23.4 this month, the highest since February's 27.0—which was the highest reading since May 2004. Both the New York (to 30.2 from 24.4) and Philadelphia (27.9 from 23.8) measures accelerated last month, while

Richmond's (12 from 19) slowed; New York's reading was its highest since September 2014. The employment measure (18.7 from 10.7) posted its best employment gain since May 2011 as Philadelphia (30.6 from 6.6) manufacturers hired at their best pace in the history of the series going back to May 1968, while New York's (15.6 from 10.6) accelerated at the best pace since March 2015. Meanwhile, Richmond (10 from 15) manufacturers continued to add jobs this month, though at a slower pace. The new orders gauge showed billings expanded at a solid but slower pace, slipping from 24.8 in September to 18.2 this month as orders growth in all three districts—New York (18.0 from 24.9), Philadelphia (19.6 from 29.5), and Richmond (17 from 20)—eased.

GLOBAL ECONOMIC INDICATORS

US PMI Flash Estimates (*link*): Private-sector growth accelerated this month at its fastest pace since the start of the year. The C-PMI flash estimate rebounded to 55.7—just shy of January's 14-month high of 55.8—after falling in August (to 54.8) for the first time in six months. The M-PMI (to 54.5 from 53.1) climbed to a nine-month high, while the NM-PMI (55.9 from 55.3) was at a two-month high. According to the report, October's upturn was supported by the fastest acceleration in manufacturing production in eight months, along with another robust advance in service-sector output. The latest survey displayed a solid gain in private sector employment, led by the steepest rise in factory payrolls since June 2015. Meanwhile, input price inflation moderated from September's three-year high.

Eurozone PMI Flash Estimates (*link*): Growth in the Eurozone in October continued to expand at a robust pace, led by the manufacturing sector. Meanwhile, input prices accelerated at the fastest pace in six months. October's flash estimate shows the C-PMI slipped from 56.7 to 55.9, not far from April/May's 56.8—which was the best pace since spring 2011. The M-PMI (to 58.6 from 58.1) jumped to an 80-month high, while the NM-PMI (54.9 from 55.8) fell to a two-month low, though remained at an elevated level. A key highlight of the latest survey is the sharp and accelerated rise in employment across the private sector, with manufacturing jobs growth the strongest since the data began in June 1997; service sector's was the best in seven months. Output and new orders growth in the manufacturing sector continued to outpace the service sector. By country, France's C-PMI (57.5 from 57.1) was at a 77-month high, while Germany's (56.9 from 57.7) eased slightly from September's 77-monh high. The M-PMIs show a similar story, with France's (56.7 from 56.1) reaching a 78-month high, while Germany's (60.5 from 60.6) was little changed from September's 77-month high. Meanwhile, France's NM-PMI (57.4 from 57.0) climbed to a seven-month high, while Germany's (55.2 from 55.6) eased to a two-month low. Growth in the rest of the Eurozone was solid, though saw the slowest growth in a year. The slowdown was linked to weaker service-sector growth; manufacturing's output increased at the best pace in four months.

Japan M-PMI Flash Estimate (*link*): Japan's manufacturing activity this month continued at a healthy clip, according to the flash estimate, though did slow a bit. The M-PMI fell to 52.5 from 52.9 in September, continuing to bounce around February's cyclical high of 53.3. October's report shows growth in production and orders slowed, while jobs growth increased at a faster rate. Meanwhile, business confidence softened to an 11-month low.

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