MORNING BRIEFING
November 1, 2017

AC vs DC

See the collection of the individual charts linked below.

(1) Alternating vs direct currents in DC and in earnings. (2) Jolt from DC. (3) Trick or treat? (4) Instant gratification vs phasing in tax reform. (5) Rubbing SALT: Raising taxes to cut taxes. (6) Will growth pay for tax cut? No money-back guarantee. (7) Forward revenues and earnings remain charged up. (8) Consumers are happy because jobs are plentiful and wages are rising faster than prices.

Strategy I: Alternating Currents. "DC" is the acronym for "the District of Columbia." In engineering, it stands for "direct current." In Washington, DC, everything runs on "AC," i.e., "alternating current."

The stock market stumbled on Monday after receiving a jolt from DC. The day before Halloween, Bloomberg spooked the market by reporting that the Republicans are talking about slowly phasing in their proposed cut in the corporate tax rate:

"House tax writers are discussing a gradual phase-in for President Donald Trump and Republican leaders' proposed corporate tax-rate cut—on a schedule that would put the rate at 20 percent in 2022, according to a member of the chamber's tax-writing committee and a person familiar with the discussions." Under discussion is a cut of 3ppts per year from 35% to 20%. Trump wants the full cut upfront.

Meanwhile, our good friends at Capital Alpha Partners observe that phase-ins are the norm in DC. James Lucier wrote on Monday: "As a general rule, significant changes in the corporate and individual rate structures are always phased in to minimize the distortions and disruptions that can result from too sudden a revision. We expect that almost every major change in corporate tax provisions in the reform bill will be subject to some phase-in or other, including for example changes in the tax treatment of interest expense."

Also on Monday, special counsel Robert Mueller, who is investigating Russian meddling in the 2016 elections, accused two former Trump campaign officials of not paying taxes on millions of dollars in income and obtained a guilty plea from a third, who admitted that he had lied to federal authorities about contacts with Russian go-betweens. This is a significant distraction for the Trump administration at a time when the Republicans must move quickly to achieve tax reform before next year's midterm elections.

Trump's tax reform agenda seemed dead in the water following the repeated failures of the Republicans to repeal and replace Obamacare. However, last Thursday, the House of Representatives narrowly passed a budget resolution that clears the way for Congress to fast-track tax reform legislation. The budget includes reconciliation rules that will allow the Senate to pass tax reform with only a simple majority rather than the usual 60 to overcome a filibuster.

A significant hurdle for the Republicans is to come up with some tax revenues to pay for the tax cuts. Read that sentence again. Raising taxes to lower taxes is the AC way that DC operates. The current Republican plan would eliminate deductions for state and local taxes (SALT), which would raise more than a trillion dollars over the next 10 years. The CNN report on this subject observed that eliminating SALT would make "it a huge source of revenue for their overall plan to reform the tax code." The story didn't comment on the irony of this proposal.

Melissa and I wrote about the importance of eliminating the SALT deduction in the 10/4 *Morning Briefing* titled, "Taxing Tax Reform." We observed that the Trump administration needs the $1.3 trillion from the elimination of SALT because the fast-track reconciliation process allows for only $1.5 trillion in tax cuts. We wrote: "That's a really big sticking point for Republicans from high-tax states who want to keep that tax break."

The bottom line, it seems, is that the big tax cut that the administration would like can't be sold with only the money-back guarantee that it will pay for itself. So the administration has to raise taxes to cut taxes. That became obvious once the decision was made not to cut spending in any significant way. To get a revenue-neutral tax cut requires a big assumption that growth will pay for the tax cut or additional tax revenues from other sources …or both.

Strategy II: Earnings Power. While DC continues to be powered by alternating currents, earnings remain charged up on direct current. Joe and I may have to revise our earnings estimates for next year depending on how tax reform plays out. However, we believe that there's plenty of power in earnings without tax reform.

Forward earnings rose to fresh record highs at the end of October for the S&P 500/400/600 (*Fig. 1*). The forward earnings for the S&P 500 has been rising in record territory since the week of October 7, 2016. That's when the Energy-led earnings recession ended. We started to write about that last summer. And here we are with S&P 500 forward earnings up 9.7% y/y (*Fig. 2*). It's the same story for forward revenues, with the S&P 500 composite up 5.3% y/y (*Fig. 3*).

Also remarkable is that the forward profit margin of the S&P 500 rose to a record high of 11.1% during the 10/19 week (*Fig. 4*). This has certainly frustrated the many bears who've been warning that the profit margin is at a cyclical high and vulnerable to reverting to its mean. Here is the performance derby for the profit margins of the S&P 500 sectors through mid-October: IT (20.7%, record high), Real Estate (17.3), Financials (16.3), Telecom Services (11.8), Utilities (11.3), record high), S&P 500 (11.1), Health Care (10.7), Materials (10.6, record high), Industrials (9.5), Consumer Discretionary (7.6), Consumer Staples (6.8), and Energy (4.9).

US Consumer: Happy Days. We live in happy times. How can that be given all the unhappy happenings in DC these days? Apparently, we are all tuning out the political static and focusing on what matters most: jobs. While our politicians continue to promise policies that will create more jobs, we are doing just that despite Washington. As a result, consumer confidence is soaring. Consider the following happy developments:

(1) *Consumer confidence*. Both the Consumer Sentiment Index (CSI) and the Consumer Confidence Index (CCI) jumped in October (*Fig. 5*). Debbie and I focus on the average of the two, which we call the "Consumer Optimism Index" (COI) (*Fig. 6*). During October, the overall COI jumped to 113.3, the highest since December 2000. Its current conditions component rose to 133.8, the highest since March 2001, while its expectations component rose to 99.8, its best reading since January 2004.

(2) *Availability of jobs.* Among the plethora of series included in the CSI and CCI surveys of consumer confidence, our favorites are the jobs plentiful, jobs hard to get, and jobs available series from the latter source (*Fig. 7*). During October, 36.3% of respondents agreed that jobs are plentiful, the highest reading since June 2001. The jobs-hard-to-get percentage fell to 17.5%, the lowest since August 2001.

It tends to be highly correlated with the unemployment rate, and suggests that the jobless rate is still falling (*Fig. 8*).

(3) *Wages.* In the past, there was a reasonably good correlation between wage inflation and the jobs plentiful series (*Fig. 9* and *Fig. 10*). This was so using the yearly percent change in either average hourly earnings or the Employment Cost Index (ECI). The latest data show that average hourly earnings for production and nonsupervisory workers rose 2.5% y/y during September, while wages and salaries in the ECI rose 2.6% during Q3. Both remain surprisingly low given the plentitude of jobs.

So why are consumers so happy? Jobs are plentiful and wages rising faster than prices. The PCED rose 1.6% y/y during September.

CALENDARS

US. **Wed:** ADP Employment 220k, Total & Domestic Motor Vehicle Sales 17.5mu/13.6mu, ISM & Markit M-PMIs 59.5/54.5, Construction Spending 0.1%, MBA Mortgage Applications, EIA Petroleum Status Report, FOMC Announcement 1.125%. **Thurs:** Productivity & Unit Labor Costs 2.5%/0.6%, Jobless Claims 235k, Challenger Job-Cut Report, Weekly Consumer Comfort Index, EIA Petroleum Status Report, Dudley. (*Wall Street Journal* estimates)

Global. **Wed:** UK-MPI 55.9, China Caixin/Markit 51.0, Japan M-PMI, Poloz, Wilkins. **Thurs:** Germany Unemployment Change & Unemployment Rate -10k/5.6%, Eurozone, Germany, France, and Italy M-PMIs 58.6/60.5/56.7/56.5, Japan Consumer Confidence 43.6, BOE Bank Rate & Asset Purchase Target 0.50%/435b, BOE Inflation Report. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Q3 Earnings Season Monitor (*link*): With over 61% of S&P 500 companies finished reporting Q3-2017 earnings and revenue results through midday Tuesday, their percentage surprise and y/y growth results are mostly weaker compared to the same point during the Q2 earnings season, but more companies have reported positive y/y revenue and earnings growth. Of the 306 companies in the S&P 500 that have reported, 75% exceeded industry analysts' earnings estimates, by an average of 5.1%; they have averaged a y/y earnings gain of 8.9%. At the same point during the Q2-2017 reporting period, a lower percentage of S&P 500 companies (71%) had beaten consensus earnings estimates by a higher 5.7%, and earnings were up a higher 14.3% y/y. On the revenue side, 66% beat sales estimates so far, with results coming in 1.5% above forecast and 6.3% higher than a year earlier. At this point in the Q2 season, a higher 69% had exceeded revenue forecasts by a lower 1.2%, and sales rose a lower 5.5% y/y. Q3 earnings results are higher for 73% of companies, vs 64% at the same point in Q2, and revenues are higher for 82%, vs 83% 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 very encouraging. Q3-2017 should mark the fifth straight quarter of positive y/y earnings growth despite the negative impact of the three hurricanes. We believe growth will fall back into the 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

Consumer Confidence (*link*): Consumers are euphoric! Consumer confidence in October was at its highest level in almost 17 years, according to the Conference Board, coming on the heels of the University of Michigan's report that sentiment was at a 13-year high. The Consumer Confidence Index rose for the fourth consecutive month, from 117.3 in June to 125.9 last month—its highest reading since December 2000! (September's reading was revised up to 120.6 from the initial estimate of 119.8.) The present situation component rebounded from 146.9 last month to 151.1 this month—the highest since July 2001, while the expectations component advanced for the second month from 101.7 in August to a seven-month high of 109.1 in October, climbing back toward March's 112.3 peak. Consumers' view of the current job market is at a 16-year high—with those saying jobs are plentiful (to 36.3% from 32.7%) at the highest percentage since June 2001, and those saying jobs are hard to get (17.5 from 18.0) at the lowest since August 2001. As for the six-month jobs outlook, the percentage expecting more jobs (18.9%) continued to surpass those expecting fewer jobs (11.8), with the spread improving for the second month, to 7.1ppts, after narrowing steadily from 11.1ppts in March to 3.6ppts in August.

Employment Cost Index (*link*): Labor costs accelerated at the fastest pace in two and a half years during Q3, led by benefits' costs. Private industry compensation climbed 0.8% during Q3, pushing the yearly rate up to 2.5% y/y, the biggest gain since Q1-2015. Benefits' costs accelerated 0.7%—its largest quarterly gain since Q2-2014—with the yearly rate climbing to a 10-quarter high of 2.4%. Meanwhile, private wages & salaries also posted a 0.7% increase during the quarter, though the yearly rate (2.6%) has been stalled around this pace the past six quarters.

GLOBAL ECONOMIC INDICATORS

Eurozone CPI Flash Estimate (*link*): October's CPI rate is expected to slip to 1.4% y/y, down from 1.5% the prior two months**,** remaining below the ECB's goal of just under 2.0% for the sixth month since April's 1.9%**.** Looking at the main components, energy (to 3.0% from 3.9% y/y) is once again expected to have the highest annual rate, though has slowed for the second month from August's 4.0%. Rates for services (1.2 from 1.5) and non-energy industrial goods (0.4 from 0.5) are also expected to ease. Meanwhile, the yearly rate for food, alcohol & tobacco (2.4 from 1.9) is expected to accelerate at its fastest clip since February. The core rate—which excludes energy, food, alcohol, and tobacco—is expected tick down to 0.9% y/y, the first reading below 1.0% since May.

Japan Industrial Production (*link*): Japan's industrial production in September continued to bounce around cyclical highs. Headline output fell 1.1% after a 2.0% increase and a 0.8% decrease the previous two months. Upon the release of September's data, METI maintained its assessment that industrial production is showing signs of improving. Leading September's decline was a 5.6% drop in output of electronic parts & devices, along with a 2.4% slide in production of general & production machinery; partially offsetting these losses were gains in output of chemicals excluding drugs (7.6%), petroleum & coal products (4.4), and non-ferrous metals (0.8). Meanwhile, manufacturers polled by METI said they expect production to rise 4.7% in October and fall 0.9% in November.

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