Yardeni Research, Inc.

MORNING BRIEFING
November 2, 2017

High on Lithium & Paint

See the collection of the individual charts linked below.

(1) Materials: The comeback sector. (2) Basic Materials industries are unimpressive. (3) It's all chemicals and paints. (4) Lithium is no laughing matter. (5) OPEC's surprising compliance boosts Energy sector. (6) The price is right for US frackers. (7) US motorists driving more on less gas. (8) Bitcoin makes less sense than tulip bulbs. (9) More fake news?

Sectors I: Materials Improvement. As 2017 enters the homestretch, the S&P 500 Materials sector has surged ahead and become the second-best-performing sector in the S&P 500. Up 18.4% ytd, Materials still trails the Tech sector, but it has broken away from the other S&P 500 sectors, even edging past Health Care.

Here's the performance derby for the S&P 500 sectors ytd through Tuesday's close: Tech (35.7%), Materials (18.4), Health Care (17.7), S&P 500 (15.0), Financials (14.1), Utilities (13.2), Consumer Discretionary (13.0), Industrials (12.5), Real Estate (5.4), Consumer Staples (2.8), Energy (-9.3), and Telecom Services (-16.1) (*Fig. 1*).

The outperformance of Materials owes much to the expected surge in demand for lithium, related to the anticipated move to electric vehicles from those run by the gasoline-fueled combustion engine. Here's a quick look at what's pushing this sector materially higher:

(1) *Summer surge*. The Materials sector's acceleration started in late summer. From August 15 through Tuesday's close, the sector returned 9.4%, on par with the Tech sector's market-leading 9.91% return.

Ironically, the Materials sector isn't being driven by companies selling raw materials. After a strong rally from mid-2015 to mid-2016, the CRB raw industrials index has flat-lined in recent months, albeit near its highest levels. It's up only 0.6% ytd (*Fig. 2*). Accordingly, the S&P 500 Steel industry index has fallen 2.8% ytd, while Copper (6.0%) and Gold (6.1%) are up by mid-single-digit levels. Instead, the Materials sector is being propelled higher by Specialty Chemicals, up 29.0% ytd, Diversified Chemicals (24.9%), Industrial Gases (18.0), and Fertilizers & Agricultural Chemicals (15.3) (*Fig. 3*).

(2) *Thank the chemicals*. Within the Specialty Chemicals industry, the standout performer is Albemarle, which gets roughly a third of its revenue from the production and sale of lithium. Its shares are up 63.7% ytd through Tuesday's close, propelled by hopes that electric cars will become commonplace and the demand for lithium batteries will soar.

The second-best-performer in the Specialty Chemicals industry is Sherwin-Williams, up 47.0% ytd. It has benefitted from the boom in housing and its acquisition of Valspar. The deal helped Sherwin report a Q3 37.4% jump in sales y/y to $4.5 billion. Earnings per share in Q3 fell to $3.33 from $4.08 a year earlier; however, that includes a $1.42 a share charge for acquisition-related costs and 27 cents of expenses and lost sales related to the hurricanes. PPG Industries—another industry member that also produces paint in addition to coatings and specialty materials for industries like automobiles and aerospace—is up 22.7% ytd.

Since the start of the year, analysts have been boosting their expectations for revenue and earnings growth in the Specialty Chemicals industry. It's now expected to grow revenue by 8.7% and earnings by 14.5% over the next 12 months (*Fig. 4*). The industry's forward P/E also has climbed, to 22.5 from a low of 18.0 in January 2016 (*Fig. 5*).

(3) *More lithium*. The S&P 500 Fertilizer & Agricultural Chemicals industry stock price index has helped the Materials sector move ahead as well. Momentum comes less from the farm and more from the need for batteries. The shares of fertilizer producers CF Industries and Mosaic are up 20.7% and down 23.8%. Meanwhile, the shares of Monsanto, which sells seeds and herbicides to farmers, have climbed 15.1%.

But that pales in comparison to the 64.2% ytd gain in FMC's shares. Like Monsanto, FMC produces herbicides and other products for the agricultural market. That segment kicked in $583 million in Q2, or 88.7% of total revenue. The lithium segment generated $74 million of revenue, or 11.3% of the total, but that may be where investors are focused. Last year, FMC announced plans to triple its lithium production by 2019 in response to the "rapid growth of electric vehicle sales and strong demand for FMC's battery grade lithium hydroxide."

Analysts expect FMC's earnings will jump to $5.15 a share in 2018, up from $2.43 this year. Because of the major jump expected in earnings, FMC shares trade at 18.0 times 2018's estimated EPS despite their strong run. Earnings growth is expected to slow sharply in 2019, to 13.6%.

The S&P 500 Fertilizer & Agricultural Chemicals industry is expected to see revenues grow by 9.8% and earnings jump by 20.3% over the next 12 months (*Fig. 6*). And its forward P/E, at a recent 23.4, looks reasonable compared to prior booms (*Fig. 7*). Just remember that developments with electric vehicles may affect this industry more than events down on the farm.

Sectors II: Energized. The S&P 500 Energy sector is still in negative territory ytd, down 9.3%, but it too has enjoyed a healthy rally since late summer. Since August 15, the sector has gained 7.9%, right behind Materials and Tech. The Energy sector has been propelled by the Oil & Gas Drilling industry, up 19.2% since August 15, Oil & Gas Exploration & Production (13.7%), and Oil & Gas Refining & Marketing (13.3). Let's take a quick look at what's going on in the energy patch:

(1) *Production cuts working*. The price of oil has climbed over that period on expectations that OPEC would extend its current deal to cut crude output. At a recent $61.37 per barrel, Brent crude oil has risen 36.9% from its June 21, 2017 low of $44.82 (*Fig. 8*).

"The higher-than-expected compliance with the deal has been a major factor behind the upswing in prices, analysts say. OPEC's compliance in the first three quarters of 2017 was close to 90%, J.P. Morgan analysts estimate, adding that Saudi Arabia was 'clearly doing whatever it takes to balance the markets' with a cut that was 20% above their required target," reported a 11/1 *WSJ* article. Wall Street analysts surveyed by the *Journal* now expect Brent crude to average $54 a barrel next year, up $1 from their estimate in September. As of March, world production has been flattish, helped by cutbacks by Saudi Arabia and Russia (*Fig. 9* and *Fig. 10*).

(2) *Swing factor*. In addition to OPEC, US production will be a wildcard. Shale producers are often profitable when the price of a barrel of oil tops $50; since that's the case again, producers are expected to bring capacity back into the market.

US crude output in August dipped slightly to 9.203 mbd from 9.234 mbd in July, according to the latest report from the US Energy Information Administration. The amount of gasoline the US produced dipped over the past year, while the amount of distillate has continued to climb (*Fig. 11* and *Fig. 12*). The US rig count and crude oil stocks have also come off their recent peaks (*Fig. 13* and *Fig. 14*).

(3) *Important chart*. In addition to the supply side of the equation, investors would be wise to watch demand for crude and gasoline as well. In the US, consumers have been driving more miles using less gas (*Fig. 15*). More efficient gasoline-powered cars as well as the onset of electric cars may be reducing the amount of gasoline used even as miles traveled keeps increasing. Perhaps the higher the price of lithium goes, the more nervous investors in crude should get.

Bitcoin: More than Chump Change? Bitcoin surged past the $6,000 marker last week after receiving an implicit endorsement by the CME Group, which announced plans to introduce bitcoin futures by yearend (*Fig. 16*). The contract will bet on the value of bitcoin, but it will trade and settle in dollars. The CBOE Global Markets indicated earlier this year that it too plans to introduce a bitcoin futures contract.

A futures market may make traditional institutional investors more willing to invest in bitcoin. A 10/31 Bloomberg article explained: "A functioning derivatives market could help professional traders and investors access the incredible volatility inherent in bitcoin without having to trade on unfamiliar venues that may risk anti-money laundering and know-your-customer rules. It will also allow traders to hedge their cash positions in the digital currency, which to date has been difficult to do."

Another Bloomberg article on 10/31 speculated that the development of a derivatives market for bitcoin would ease the way to creating exchange-traded funds (ETFs) that purchased bitcoin futures. So far, the Securities and Exchange Commission has denied a bitcoin ETF proposed by Tyler and Cameron Winklevoss "saying necessary surveillance-sharing agreements were too difficult given that "significant markets for bitcoin are unregulated.'" However, the CME and CBOE are both closely regulated, so an ETF based on bitcoin futures stands a better chance. Ledger X won approval by the Commodity Futures Trading Commission to sell swaps and options based on bitcoin.

From our perspective, the creation of swaps, futures, and ETFs based on the price of bitcoin doesn't validate the price of bitcoin. It just means that a $1 increase or decrease in bitcoin will be leveraged and affect far more investors than ever before.

We still don't see what gives bitcoin its value, beyond being worth what the next guy is willing to pay for it. Bitcoin isn't issued by a government that can raise money from taxes. Nor does bitcoin produce anything that creates earnings. It can't be used to power an engine, like nature gas. And it's not even pretty to wear, like gold. We've never seen an article that tries to justify the price of bitcoin using some valuation metric. Even during the 2000 Internet bubble, there were eyeballs to count.

One last thought arises in the wake of recent headlines about fake news from Russia on our elections distributed via Facebook and other Internet sites. Much of the news about bitcoin and other cryptocurrencies is distributed by Internet sites devoted to the subject. They are not owned by large media outlets. One site lists an address in Oslo, Norway. Another is owned by a US firm that also owns a brokerage that trades bitcoin. Some sites have no way to contact the owners. Many of the writers don't have traditional journalism backgrounds—which many readers may consider a positive, not a negative. But taken all together, these points at the very least raise an eyebrow and perhaps deserve further consideration.

CALENDARS

US. 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. **Fri:** Total & Private Nonfarm Payroll Employment 325k/320k, Unemployment Rate & Participation Rate 4.2%/63.0%, Average Hourly Earnings 0.2%m/m/2.7%y/y, Average Workweek 34.4hrs, Merchandise Trade Balance -$43.4b, Factory Orders, ISM & Markit NM-PMIs 58.6/55.9, Baker-Hughes Rig Count, Kashkari. (*Wall Street Journal* estimates)

Global. 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. **Fri:** UK Composite & NM-PMIs 53.8/53.3, Canada Employment Change & Unemployment Rate 15.5k/6.2%, China Composite & NM-PMIs. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): Our Bull/Bear Ratio (BBR) jumped to 4.41 this week—the highest reading March 1987! Bullish sentiment posted its fourth straight reading of 60.0% or above, increasing steadily the past seven weeks from an 11-month low of 47.1% to 63.5% this week—near its high of 64.9% posted in early 1987. The correction count fell six of the past seven weeks from 32.7% to 22.1%—near its low for the year of 20.4% during the final week of February. Bearish sentiment sank to 14.4% this week, the fewest bears since early May 2015; it was at 20.2% seven weeks ago. This is the fourth week with the bears below the narrow 16.5%-18.3% range shown most of this year. The AAII Ratio slipped for the second week last week to 54.5% after rebounding from 52.0% to 59.7% the week before. Bullish sentiment was at 39.6% last week, showing little change over the two-week span, while bearish sentiment rose from 26.9% to 33.0% over the period.

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 was steady at 5.5%. 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 ticked down to 11.4% from a nine-month high of 11.5%. 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 5.3% is only 0.2ppts lower and STEG of 10.2% is 1.2ppts 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 6/11. Health Care and Telecom were the only sectors 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 16.7 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, which matches the post-election high from 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 1.33 compares to a record high of 1.56 in May 2016, and its P/E of 26.7 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 Industrials, Real Estate, and Utilities. In the latest week, Real Estate's forecasted 2017 margin rose 0.8ppts to 19.1% due to gains from property sales. Also in the latest week, the forecasted forward profit margin edged up 0.1ppt for Energy, Tech, and Utilities; Industrials dropped 0.2ppts, and Telecom and Real Estate ticked down 0.1ppt. Here's how they rank based on their current 2018 forecasts: Information Technology (to 20.8% in 2018 from 20.1% in 2017), Real Estate (16.9, 19.1), Financials (16.6, 15.0), Telecom (11.7, 11.7), Utilities (11.4, 11.2), S&P 500 (11.2, 10.5), Health Care (10.8, 10.5), Materials (10.7, 9.6), Industrials (9.4, 8.8), Consumer Discretionary (7.6, 7.4), Consumer Staples (6.8, 6.5), and Energy (5.2, 4.0).

S&P 500 Q3 Earnings Season Monitor (*link*): With over 65% 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 326 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 5.8%, and earnings were up a higher 12.9% y/y. On the revenue side, 67% beat sales estimates so far, with results coming in 1.5% above forecast and 6.5% higher than a year earlier. At this point in the Q2 season, a higher 69% had exceeded revenue forecasts by a lower 1.3%, and sales rose a lower 5.7% y/y. Q3 earnings results are higher for 72% of companies, vs 64% at the same point in Q2, and revenues are higher for 82%, vs 84% a quarter ago. Although these figures will continue to change as more Q3-2017 results are reported in the coming weeks, particularly for the insurers and retailers, 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

ADP Employment (*link*): "The job market remains healthy and hiring bounced back with one of the best performances we've seen all year," according to ADP. In October, private industries added 235,000 to payrolls after a hurricane-related slowdown in September to a downwardly revised 110,000 (from 135,000), its weakest hiring since last fall. Service-providing industries (150,000) accounted for roughly two-thirds of October's gain, though goods-producing industries (85,000) posted another strong performance, with both construction (62,000) and manufacturing (22,000) companies recording solid gains. The big increase in construction shows the rebuilding from the hurricanes is in full swing. Within service-providing, once again the biggest increases came from professional & business services (109,000), leisure & hospitality (45,000), and health care & social assistance (44,000). Large companies (90,000) held the number-one slot on the leader board, posting one of their strongest gains this year, with services-providing industries adding 72,000 payrolls and goods-producing adding 18,000. Small businesses moved up to the number-two spot, adding 79,000 to payrolls last month, after recording the first decline since the end of 2013 during September (-16,000)—on a hurricane-related loss in services-providing jobs. These jobs rebounded 47,000 in October, more than reversing September's 29,000 drop, while goods-producing companies added 32,000 jobs last month—the second highest gain this year. Medium-sized companies claimed the bottom slot, adding 66,000 to payrolls—with a mix of 35,000 goods-producing and 32,000 services-providing.

Manufacturing PMIs (*link*): Manufacturing activity in October remained powerful according to ISM's survey, and posted its best growth in nine months according to Markit's. The ISM M-PMI edged down to 58.7 after soaring to 60.8 last month—which was its best performance since May 2004! October's slowdown was slight: The new orders (to 63.4 from 64.6) and production (61.0 from 62.2) indexes were both above 60.0 for the fifth month, while the supplier deliveries (61.4 from 64.4) gauge was above for the second month. Meanwhile, the employment (59.8 from 60.3) measure slipped just below 60.0 after moving above in September for the first time since June 2011. The inventories (48.0 from 52.5) component was the outlier—moving back into contraction territory. Markit's M-PMI (54.6 from 53.1) showed manufacturing activity improved in October, nearing its 55.0 peak rate at the start of the year. According to the report, both production and new orders accelerated, while manufacturers expanded their payrolls at the strongest rate since June 2015.

Auto Sales (*link*): Motor vehicle sales in October remained elevated around September's 12-year high, boosted in part by consumers in hurricane-hit parts of the country replacing flood-damaged vehicles. Sales slowed slightly to 18.1mu (saar) last month, after shooting up from 16.1mu in August to 18.6mu in September—which was the best pace since July 2005. Light-truck sales, which led September's rebound, were little changed at 9.5mu (saar) in October, after jumping 1.4ppts in September to 9.7mu—which was the strongest showing since the summer of 2005. October domestic car sales slipped to 4.8mu (saar) after rebounding to 5.0mu in September, which was the first reading with a 5-handle in nine months. Sales of imports (3.8mu, saar) were just shy of September's 3.9mu, which was the fastest pace since August 2009.

Construction Spending (*link*): Construction spending remained stalled in record territory in September. Total investment advanced 0.4% in the two months through September, following a two-month slide of 1.7%, as public construction building rebounded 3.4% over the two-month period. Private construction investment contracted for the third straight month by a total of 1.4%. Within private construction spending, nonresidential investment fell for the fourth month, by a total of 3.6%, while residential investment was unchanged after rising three of the prior four months by 1.5%. Within residential investment, single-family construction remains strong, advancing 11 of the last 12 months by a total of 11.9%, while multi-family (0.6%) construction posted its first increase in five months, after a four-month drop of 4.5%. Meanwhile, home-improvement spending has retreated two of the last three months, by 2.8%, after jumping to a new record high in June.

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