MORNING BRIEFING
November 7, 2017

Animal Spirits Revisited

See the collection of the individual charts linked below.

(1) The disconnect between soft and hard data is gone. (2) Boom ahead? (3) Nirvana scenario could set stage for Meltup scenario. (4) Q1-2018 could test boom hypothesis. (5) Surprise Index makes a not-so-surprising comeback. (6) More buying and less renting of homes. (7) Unemployment rates confirm tight labor market. (8) CEOs remain upbeat, and it shows in capital spending. (9) Transportation indicators are booming. (10) Business surveys are hot. (11) S&P 500 forward earnings making weekly record highs. (12) Are there too many bulls?

US Economy: Roaring. Late last year and early this year, there was lots of chatter about the disconnect between soaring measures of "animal spirits" after Trump won the presidential race and lackluster economic indicators in the US. The chatter has died down because "hard" economic indicators have turned stronger, while "soft" ones (i.e., mostly surveys of confidence) remain highly spirited. Have you noticed that since Election Day, there's been less and less chatter about a "New Normal" and "secular stagnation?"

It may be time to consider the possibility that the US economy is finally entering a boom phase. We aren't there yet, but there is evidence that the pace of real economic activity is quickening. On the other hand, there's no evidence that inflationary pressures are starting to build. This is a Nirvana scenario for the stock market. The only risk might be that investors become overly exuberant and cause a Meltup scenario. On October 9, I raised my subjective odds of such an event to 55% from 50% on August 2, 40% on March 6, and 30% on January 24, 2013. (See our 10/9 *Morning Briefing*.) In other words, it is now actually my most likely scenario, with the Nirvana scenario at 20% and the Meltdown scenario at 25%.

The test of my boom hypothesis might be the performance of the economy during Q1-2018. The first quarter has been a clunker since the start of the current expansion. Here are the averages for the growth rates (saar) of real GDP for each of the four quarters since 2009: Q1 (0.5%), Q2 (2.4), Q3 (2.3), and Q4 (2.4). There's definitely a strange pattern of weakness during Q1 even though the data are seasonally adjusted (*Fig. 1*). This year matches the pattern but with stronger growth rates as follows: 1.2%, 3.1%, 3.0%, and 3.3%. That last number is the latest forecast of the Atlanta Fed's GDPNow Model for Q4-2017.

Debbie and I will be monitoring the hard data during Q1 to see whether the first-quarter curse disappears, as we expect it might given the mounting signs of an economic boom. We will also be tracking the daily Citigroup Economic Surprise Index (CESI), which has exhibited a similar pattern. From 2010-2017 it has tended to peak during Q1, falling during the quarter and immediately afterwards before moving higher over the rest of the year (*Fig. 2*). This year, the CESI plunged from a peak of 57.9 during March 15 to a low of -78.6 on June 16. It has recovered since then, and soared in recent days to 40.9 at the end of last week. The hard data are turning harder in the US, while the soft data remain strong. Consider the following:

(1) *Consumer confidence & Earned Income Proxy.* As Debbie and I noted last week, the Consumer Optimism Index (COI) soared during October to the highest level since December 2000 (*Fig. 3*). We calculate this index by averaging the Consumer Confidence Index (CCI) and the Consumer Sentiment Index (CSI). Leading the way last month was the COI's current conditions component, which rose to the highest reading since March 2001.

The heady optimism in the COI reflects the continuing improvement of labor market conditions, which are boosting incomes. Indeed, our Earned Income Proxy for private-sector wages and salaries rose 0.2% m/m and 4.1% y/y during October to a new record high (*Fig. 4*).

(2) *Renters vs. owner-occupiers.* Last month, the CCI for 35- to 54-year-old consumers jumped to the highest level since October 2000 (*Fig. 5*). This age group tends to be married, have kids, and trade up to bigger homes. In other words, they are among the economy's most reliable spenders.

More of them along with the younger cohort of Millennials (aged 21-36 this year) seem to be buying rather than renting their homes. Census data released last week show that over the past year through Q3, the number of households who are renters fell 49,000, based on the four-quarter average, the first decline in this series since Q1-2005 (*Fig. 6*). Owner-occupiers increased 834,000 over this same period, the most since Q3-2006.

(3) *Job surveys & unemployment rate.* The CCI's "jobs-hard-to-get" series continues to closely track the unemployment rate (*Fig. 7*). During October, the former fell to 17.5%, the lowest since August 2001, while the latter dropped to 4.1%, the lowest since December 2000. The jobless rate for adults fell to 3.7% last month, the lowest since March 2001. It dropped to just 2.0% for adults with a college education. The short-term unemployment rate (for those unemployed for less than 27 weeks) declined to just 3.1%, the lowest since October 1953 (*Fig. 8*).

(4) *CEO confidence and capital spending.* The quarterly CEO Outlook survey conducted by the Business Roundtable found that 94.5% of top executives were upbeat (*Fig. 9*). That's up from 69.6% a year ago before the presidential election. This series tends to be a good coincident indicator of the growth rate of capital spending in real GDP on a y/y basis, especially for equipment spending. Real capital spending is up 4.4% y/y, with spending on equipment and structures up 5.9% and 3.3% respectively.

Nondefense capital goods orders excluding aircraft is up 8.3% y/y through September (*Fig. 10*). It has been staging a solid recovery from the energy-led recession during 2015. Over the past three months through September, it is up 11.9% (saar), the best such growth rate since August 2014.

(5) *Transportation stocks & indicators.* The Dow Jones Transportation Average has been rising into record territory along with the Dow Jones Industrials Average this year, providing a bullish Dow Theory signal (*Fig. 11*). Both railcar loadings of intermodal containers and truck tonnage have been making new highs recently (*Fig. 12*).

(6) *Regional business surveys & M-PMI.* Remarkably, the average of the five composite business conditions indexes compiled by the FRBs for the districts of NY, Philly, Richmond, KC, and Dallas rose to 24.1, the highest since July 2004 (*Fig. 13*). Leading the way was the employment component (18.8), with a solid reading for the orders index (21.3). The regional composites are highly correlated with the comparable national M-PMI indexes. The overall M-PMI edged down from 60.8 during September to a still-robust reading of 58.7 during October.

(7) *Stock prices & forward earnings.* Our Boom-Bust Barometer rebounded from the hurricanes to a

new record high during the week of October 28 (*Fig. 14*). Also having risen to yet another new record high is S&P 500 forward earnings (*Fig. 15*). Both these series are highly correlated with the S&P 500, which also happens to have been rising in record-high territory.

(8) *Too many bulls?* Animal spirits are soaring, according to the Bull/Bear Ratio (BBR) compiled by Investors Intelligence (*Fig. 16*). Debbie reports that the BBR jumped to 4.41 during the last week of October. That's the highest reading since early 1987, which was a year that included a nasty flash crash on Black Monday, October 19. According to the sentiment survey, the bullish percentage was 63.5%, the bearish percentage was 14.4%, with the remaining 22.1% in the correction camp. So perhaps we have nothing to fear but nothing to fear.

CALENDARS

US. Tues: NFIB Small Optimism Index 105.0, Job Openings 6.082m, Consumer Credit $17.4b. **Wed:** MBA Mortgage Applications. (*Wall Street Journal* estimates)

Global. Tues: Eurozone Retail Sales 0.6%m/m/2.8%y/y, Germany Industrial Production -0.8%m/m/4.4%y/y, RBA Cash Rate Target 1.50%, Draghi, Poloz. **Wed:** China Trade Balance $39.5b, China Foreign Direct Investment, Japan Leading & Coincident Indexes 106.6/115.9, Japan Machine Orders 2.0% y/y, BOJ Summary of October Meeting. (DailyFX estimates)

STRATEGY INDICATORS

YRI Weekly Leading Index (*link*): Our Weekly Leading Index (WLI)—a good coincident indicator that can confirm or raise doubts about stock market swings—rebounded 9.0% during the five weeks ending October 28 to within 0.2% of its record high posted during the final week of August. This follows a four-week period in which the WLI sank 8.6% on a hurricane-related jump in jobless claims. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). Our BBB jumped 16.3% over the most recent five-week period—to a new record high—as jobless claims sank to 232,500 (4-wa), the lowest since 1973! Meanwhile, the CRB raw industrial spot price index—another BBB component—has stabilized around recent lows, while the WCCI continues to bounce around recent highs.

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose to yet another record high last week for all three indexes. LargeCap's forward earnings was higher for a 15th straight week, and SMidCaps' (i.e., MidCaps' and SmallCaps') were up for an 11th week. 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 will likely slow until tax reform occurs. In the latest week, LargeCap's forward earnings rose to a six-month high of 10.0% 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 rose to a 70-month high of 14.9% from 14.4%, which compares to a six-year low of -1.3% in December 2015; and SmallCap's rose to a 13-week high of 11.1% from 10.4%, 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 11.1% and 11.2%, MidCap 10.1% and 14.4%, and SmallCap 4.2% and 22.5%.

S&P 500/400/600 Forward Valuation (*link*): Forward P/E ratios were mostly lower for the three indexes last week. Looking at the weekly valuation, LargeCap's forward P/E of 18.0 was steady at the highest level since March 2004. It's up from a 15-month low of 14.9 in January 2016 and the post-

Lehman-meltdown P/E of 9.3 in October 2008, but remains well below the tech bubble's record high of 25.7 in July 1999. SMidCap's P/Es had stalled for most of 2017 following the post-election melt-up, but are rising again recently. MidCap's forward P/E edged down to 18.2 from a 20-week high of 18.3, and is slightly higher than LargeCap's P/E again after being below during August and September for only the second time since 2009. MidCap's P/E remains below its 15-year high of 19.2 in late February and the record high of 20.6 in January 2002, but is up from a three-year low of 15.0 in January 2016. SmallCap's was down to a six-week low of 19.5 from 19.9, which compares to a 15-year high of 20.5 in early December when Energy's earnings were depressed. That's up from a three-year low of 15.5 in February 2016, and 1.4 points below SmallCap's record-high P/E of 20.9 in April 2002. Prices remain near record highs for all three indexes, but their "E"s still remain low as analysts await the passage of legislative changes to the tax rate and its positive impact on corporate earnings. Looking at their daily forward price/sales (P/S) ratios, valuations last week were mostly steady for the three indexes: LargeCap's P/S of 2.03 was at a record high, MidCap's 1.30 was down from a record high of 1.39 in early March, and SmallCap's 1.03 was down from 1.08 in early March and its record high of 1.17 in November 2013.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Q4 earnings revisions activity has turned robust as companies provided official corporate guidance following the release of their Q3 results. The S&P 500's Q4-2017 EPS forecast dropped 7 cents w/w to $34.78, but that's down only 0.6% from $34.98 at the end of Q3. The $34.78 estimate represents a forecasted pro forma earnings gain for Q4-2017 of 11.7%, compared to Q3-2017's blended estimate/actual of 7.9%, Q2's 12.3%, and Q1's 15.3%, which was the strongest growth since Q3-2011 owing mostly to easier comps for Energy. Since the end of Q3, Q4 estimates are higher for four sectors and lower for seven. Energy's Q4 forecast has risen 13.0% followed by gains for these sectors': Utilities (up 2.7%), Tech (1.4), and Telecom (1.1). Industrials' Q4-2017 forecast has fallen 9.4% for the worst decline, primarily due to the 44% decrease in GE's forecast. Other sectors with declines: Materials (-9.2), Real Estate (-6.6), Consumer Discretionary (-3.5), and Health Care (-2.2). The S&P 500's Q4-2017 forecasted earnings gain of 11.7% y/y would be its sixth straight gain after four declines. Nine of the 11 sectors are expected to record positive y/y earnings growth in Q4-2017, and four are expected to beat the S&P 500's forecasted y/y earnings gain of 11.7%. That's because analysts expect Energy to report another large profit jump in Q4 relative to very low earnings a year ago. That's better than Q3-2017, with eight sectors expected to rise y/y, but down from Q2-2017, when all 11 sectors rose y/y for the first time since Q3-2011. The latest forecasted Q4-2017 earnings growth rates vs. their blended Q3-2017 growth rates: Energy (109.1% in Q4 vs. 166.7% in Q3), Materials (25.3, 6.7), Financials (15.5, -7.3), Tech (13.6, 22.8), S&P 500 (11.7, 7.9), Utilities (9.6, -4.6), Consumer Staples (8.6, 4.1), Consumer Discretionary (7.7, 2.8), Health Care (5.1, 7.6), Industrials (4.0, 2.7), Real Estate (-0.3, 3.6), and Telecom (-0.5, -2.5). On an ex-Energy basis, S&P 500 earnings are expected to rise 10.0% y/y in Q4, up from 4.3% in Q3, which is the slowest growth since ex-Energy earnings rose just 2.2% in Q2-2016. That compares to gains of 9.6% in Q2 and 11.0% in Q1.

S&P 500 Q3 Earnings Season Monitor (*link*): With nearly 83% of S&P 500 companies finished reporting Q3-2017 earnings and revenue results through midday Monday, 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 413 companies in the S&P 500 that have reported, 73% exceeded industry analysts' earnings estimates, by an average of 5.7%; they have averaged a y/y earnings gain of 8.2%. At the same point during the Q2-2017 reporting period, a lower percentage of S&P 500 companies (72%) had beaten consensus earnings estimates by a higher 6.1%, and earnings were up a higher 12.3% y/y. On the revenue side, 67% beat sales estimates so far, with results coming in 1.3% above forecast and 5.8% higher than a year earlier. At this point in the Q2 season, a higher 68% had exceeded revenue forecasts by a lower 1.1%, and sales rose a lower 5.4% y/y. Q3 earnings results are higher for 71% of companies, vs 72% at the same point in

Q2, and revenues are higher for 79%, vs 81% a quarter ago. Although these figures will continue to change as more Q3-2017 results are reported in the coming weeks, particularly for the 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.

GLOBAL ECONOMIC INDICATORS

Global Composite PMIs (*link*): Global economic activity in October continued to grow at a steady elevated pace. The J.P. Morgan Global Composite Output Index (C-PMI) edged up from 53.9 to 54.0 last month, at the top of the 53.6 to 54.0 range during the first 10 months of this year. The NM-PMI (to 54.1 from 53.8) continues to outpace the M-PMI (53.5 from 53.3), though the latter is on a steep accelerating trend in recent months. Developed markets (55.0 from 54.6) continued to outperform emerging markets (51.5 from 51.9), with the former accelerating and the latter decelerating. The Eurozone C-PMI (56.0 from 56.7) showed growth eased a bit, though it's still one of the strongest readings in six and a half years. Growth accelerated in France (57.5 from 57.1) and slowed in Germany (56.6 from 57.7), Ireland (56.0 from 57.6), Spain (55.1 from 56.4), and Italy (53.9 from 54.3)—all robust readings. C-PMIs show rates picked up in the UK (55.8 from 54.1), US (55.2 from 54.8), Japan (53.4 from 51.7), and India (51.3 from 51.1), while slowing in China (51.0 from 51.4) and Russia (53.2 from 54.8). Meanwhile, Brazil (49.4 from 51.1) is contracting again, with its C-PMI bouncing around the breakeven point the past eight months.

Global Non-Manufacturing PMIs (*link*): Global service-sector growth in October was back up at August's two-year high. J.P. Morgan's NM-PMI climbed to 54.1 after slipping to 53.8 in September. Last month, the Eurozone NM-PMI (55.0 from 55.8) revealed the service sector expanded at a solid though slightly slower pace last month, with growth easing in Ireland (57.5 from 58.7), Germany (to 54.7 from 55.6), Spain (54.6 from 56.7), and Italy (52.1 from 53.2), while France's (57.3 from 57.0) showed stronger growth—the same pattern as the Eurozone's C-PMIs. Meanwhile, the UK (55.6 from 53.6) saw its best service-sector growth in six months; rates of expansion also accelerated in Japan (53.4 from 51.0), India (51.7 from 50.7), and China (51.2 from 50.6), though remained below the global average in all three cases. Meanwhile, service sector growth held steady in the US (55.3), according to Markit.

US Non-Manufacturing PMI (*link*): The US service sector in October grew at its fastest pace since August 2005 according to the ISM survey and matched September's robust pace according to Markit's. ISM's NM-PMI continued to rebound from July's 11-month low of 53.9—soaring to 60.1 last month. All four components were strong, though mixed: The business activity (to 62.2 from 61.3) index moved further above 60.0, while employment's (57.5 from 56.8) recorded its second best hiring pace since summer 2015. Meanwhile, the supplier deliveries (58.0) gauge remained at its highest reading since November 2005—maintaining all of September's 7.5-point surge—while the new orders (62.8 from 63.0) measure eased, though held above 60.0. Markit's NM-PMI remained at 55.3 in October, just below August's 56.0 reading—which was the highest reading since November 2015. According to the report, new business continued to expand at a solid pace, though eased to a six-month low, while job creation continued to accelerate. Business confidence improved last month, reflecting favorable market conditions and higher client demand.

Germany Manufacturing Orders (*link*): September orders rose to a new record high. The Ministry once again noted that that the solid upswing in manufacturing should continue given the high level of confidence among German businesses. Billings advanced for the fourth time in five months, climbing 1.0% in September and 6.8% over the period, with foreign orders up 1.7% and 8.5% over the comparable periods. Domestic orders ticked down 0.1% in September after a 3.2% gain and a 1.5%

loss the prior two months. A 6.3% jump in orders from within the Eurozone accounted for September's gain in foreign orders, driven by a 14.2% surge in capital goods billings; consumer and intermediate goods orders fell 5.4% and 1.0%, respectively. Billings from outside the Eurozone slumped 1.1% in September, after soaring 7.9% in August, on declines in both intermediate (-4.7%) and consumer (-1.0) goods orders; capital goods orders (0.4) were little changed. As for domestic orders, declines in intermediate (-5.1) and consumer (-2.6) goods billings more than offset a 5.2% jump in capital goods orders.

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