MORNING BRIEFING
November 14, 2017

Commodity Currents

See the collection of the individual charts linked below.

(1) In 2017, oil is up, while raw industrials are flat. (2) Oil price tends to have a lot of geopolitical noise. (3) YRI Global Growth Barometer going strong. (4) Remember the Baltic Dry Index? It is up sharply since early last year. (5) Dr. Copper is signaling that all is well. (6) Oil price up despite rebound in US output as inventories drop. (7) Relative performance: S&P 500 Materials & Energy lagging commodity prices. (8) Global industrial production at record high. (9) Emerging markets are emerging.

Commodity Markets: Mixed Signals. Since early last year, commodity markets have signaled a rebound in global economic growth following the recession that rolled through the global energy industry during 2015. While oil prices have remained strong this year, industrial commodity prices have stalled (*Fig. 1*). The price of a barrel of Brent crude oil is up 127.8% from its cyclical low on January 20, 2016. The CRB raw industrials spot price index is up 25.4% from its cyclical low on November 23, 2015. This year so far through Friday's close, the former is up 11.8%, while the latter is up only 1.2%.

Debbie and I generally give the CRB more weight as an indicator of global economic activity than we give the price of oil. That's because the price of oil often is a function of unique supply and demand factors that don't reflect global economic activity. These factors tend to be geopolitical in nature. In addition, while we and others have suggested that OPEC's days are numbered, the cartel continues to have an impact on the price of oil.

Nevertheless, we continue to monitor our homebrewed YRI Global Growth Barometer, which is the average of the CRB raw industrials spot price index and the price of oil (*Fig. 2*). Admittedly, that gives oil equal weight, which is more weight than we reckon it deserves. Our YRI-GGB is up 49% from its low of 54.9 on January 20, 2016 to its new cyclical high of 81.8 last Thursday. That's the highest it's been since December 11, 2014, but still 26.0% below its June 20, 2014 high.

To cut to the chase, the YRI-GGB confirms that the global economy is rebounding. Now let's have a look at the details:

(1) *Baltic Dry Index.* The fundamental basis of the improvement in industrial commodity prices is confirmed by the uptrend in the Baltic Dry Index since early last year (*Fig. 3*). It is up 405% since February 11, 2016 through the end of last week. This can be a funky indicator of global trade since it is very sensitive not only to the demand for dry bulk commodities but also the supply of freighters. It soared during 2006 and 2007 when global demand for commodities, especially Chinese demand, overwhelmed the availability of freighters (*Fig. 4*). It crashed when the global financial crisis unfolded during 2008, and remained relatively low during the subsequent global recovery as shipyards completed a large fleet of new freighters that had been ordered during the boom.

(2) *Dr. Copper.* Professor Copper is widely deemed to be the commodity with a PhD in economics. It is very sensitive to global economic activity, especially in China. It may soon also become a very sensitive indicator of the global transition from motor vehicles powered by fossil fuels to those running on electricity. Electric cars require more copper because that is an essential element for producing electric

motors. The CRB raw industrials includes the price of copper. However, while the CRB has stalled this year, the price of copper is up 23% ytd (*Fig. 5*).

Interestingly, the strength in the price of copper this year suggests that the strength in the price of oil this year might reflect rebounding economic activity, and not just OPEC's apparently successful efforts to keep a lid on the production. The price of oil is highly correlated with the price of copper (*Fig. 6*).

(3) *Fracking USA.* Also confirming that this year's strength in oil prices reflects better global economic activity is the fact that US oil field production rose to 9.6mbd in early November, rebounding back to its high of 2014, before the price of oil took a dive (*Fig. 7*). Despite all this US output, the price of oil is still rising. Furthermore, US stocks of crude oil and petroleum products dropped below last year's readings in early July, and just dropped below 2015's levels (*Fig. 8*).

(4) *S&P 500 Materials & Energy.* In the past, there has been a good correlation between the CRB raw industrials spot price index and the ratio of the S&P 500 Materials stock price index relative to the S&P 500 (*Fig. 9*). While the Materials index has outperformed the S&P 500 recently, it has been mostly a market performer (neither leading nor lagging the market) since the spring of 2016. The ratio has been fairly flat and range-bound since then despite last year's rebound in the CRB. The ratio has been more consistent with the CRB's stalling this year.

By the way, as Jackie explained last Thursday, much of the recent strength in the Materials sector has been related to the outperformance of Materials companies that produce lithium and stand to benefit from the greater demand for this element in the production of batteries for electric cars.

Also lagging behind the rebound in the oil price is the ratio of the S&P 500 Energy stock price index to the S&P 500 (*Fig. 10*). Seems that stock investors aren't convinced that the rise in the oil price is sustainable. They might be wrong if the price is reflecting better global demand combined with recent geopolitical concerns about the stability of the Saudi regime.

(5) *Global production.* Global industrial production data are available through August (*Fig. 11* and *Fig. 12*). They show that production rose to a record high with a y/y growth rate of 3.8%, following a growth dip during the second half of 2014 and all of 2015.

Interestingly, that dip was concentrated among the advanced economies, while the emerging economies barely skipped a beat (*Fig. 13* and *Fig. 14*).

(6) *Emerging markets.* The performance of the Emerging Markets MSCI stock price index is showing more and more signs that emerging economies are finally emerging from their dependence on commodities. In the past, this stock price index was highly correlated with the CRB raw industrials spot price index (*Fig. 15*). But they've clearly diverged as the stock index (in local currency) has soared 27% ytd. They've also broken free of their correlation with the trade-weighted US dollar (*Fig. 16*). In the past, a strong dollar weighed on the Emerging Markets MSCI. That's no longer the case, as the latter has soared to new record highs this year.

CALENDARS

US. Tues: Small Business Optimism Index 105.0, PPI-FD Headline, Core, and Core Ex Trade Services 0.1%/0.2%/0.2%, Yellen, Evans. **Wed:** Retail Sales Total, Ex Autos, Ex Autos & Gas, and Control Group 0.1%/0.2%/0.3%/0.3%, Business Inventories 0.1%, Headline & Core CPI 2.0%/1.7% y/y, Empire State Manufacturing Index 26.0, Atlanta Fed Business Inflation Expectations, MBA Mortgage Applications, EIA Petroleum Status Report, Treasury International Capital. (*Wall Street Journal* estimates)

Global. **Tues:** Eurozone GDP 0.6%q/q/2.5%y/y, Eurozone Industrial Production -0.6%m/m/3.2%y/y, Eurozone Economic Sentiment, Germany GDP 0.6%q/q/2.3%y/y, Germany CPI 0.0%m/m/1.6%y/y, Germany ZEW Expectations 19.5, Italy GDP 0.5%q/q/1.7%y/y, UK Headline & Core CPI 3.1%/2.8% y/y, Japan GDP 0.4%q/q/0.1%y/y, China Retail Sales 10.5% y/y, China Industrial Production 6.2% y/y, Draghi, Carney, Kuroda. **Wed:** Eurozone Trade Balance (euros) 21.0b, UK Unemployment Rate 4.3%. (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—was little changed in record territory during the week of November 4. It inched down 0.1%, after rebounding over the prior five weeks by 9.0%; it's now within 0.3% of its record high posted during the final week of August. (Subsequently, during the first four weeks of September, the WLI posted a hurricane-related drop of 8.4% on a spurt in jobless claims.) Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). Our BBB ticked down 0.2% after a five-week jump of 16.3% to a new record high, even as jobless claims continued unwinding its hurricane-related jump, falling from 277,000 to 231,250 during the most recent six weeks—its lowest reading since March 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 16th straight week, and SMidCaps' (i.e., MidCaps' and SmallCaps') were up for a 12th week. Momentum remains strong as the yearly change in forward earnings is up from six-year lows in early 2016, and should remain strong if tax reform occurs. In the latest week, LargeCap's forward earnings rose to a fresh 70-month high of 10.3% y/y from 10.0%, which compares to a six-year low of -1.8% in October 2015; MidCap's rose to a 70-month high of 15.1% from 14.9%, which compares to a six-year low of -1.3% in December 2015; and SmallCap's rose to a 14-week high of 11.3% from 11.1%, 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 11.4% and 11.2%, MidCap 10.4% and 14.4%, and SmallCap 6.8% and 18.9%.

S&P 500/400/600 Forward Valuation (*link*): Forward P/E ratios edged lower for a second week for the three indexes. Looking at the weekly valuation, LargeCap's forward P/E of 17.9 was down from 18.0, which was 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 have been rising again recently. MidCap's forward P/E fell to 18.0 from 18.2 and is down from a 20-week high of 18.3 at the end of October. MidCap's P/E 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 an eight-week low of 19.4 from 19.5, 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 1.5 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 2.01 is down from a record high of 2.02, MidCap's 1.28 is down from a record high of 1.39 in early March, and SmallCap's 1.00 is 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*): With the Q3 earnings season over 90% complete, Q4 earnings revisions activity has slowed considerably. The S&P 500's Q4-2017 EPS forecast dropped 1 cent w/w to $34.77, and is down only 0.6% from $34.98 at the end of Q3. The $34.77 estimate represents a forecasted pro forma earnings gain for Q4-2017 of 11.4%, down from 11.7% a week earlier and compared to Q3-2017's blended estimate/actual of 8.1%, 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 five sectors and lower for six. Energy's Q4 forecast has risen 13.8% followed by gains for these sectors: Utilities (up 2.7%), Real Estate (2.2), Tech (1.7), and Telecom (1.1). Industrials' Q4-2017 forecast has fallen 9.4% for the worst decline, primarily due to the collapse in GE's forecast. Materials is down a similar 9.4% as well, followed by Consumer Discretionary (-4.3), Health Care (-2.2), Financials (-1.4), and Consumer Staples (-1.1). The S&P 500's Q4-2017 forecasted earnings gain of 11.4% 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 11.4%. 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 (112.0% in Q4 vs. 162.1% in Q3), Materials (25.4, 7.0), Financials (14.6, -7.3), Tech (14.1, 23.5), S&P 500 (11.4, 8.1), Utilities (8.8, -4.6), Consumer Staples (8.5, 4.3), Consumer Discretionary (6.2, 3.4), Health Care (4.9, 8.0), Industrials (3.9, 2.9), Real Estate (-0.8, 3.8), and Telecom (-1.7, -2.8). On an ex-Energy basis, S&P 500 earnings are expected to rise 9.4% y/y in Q4, up from 5.8% 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 over 91% of S&P 500 companies finished reporting Q3-2017 earnings and revenue results through midday Wednesday, 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 457 companies in the S&P 500 that have reported, 72% exceeded industry analysts' earnings estimates, by an average of 5.5%; they have averaged a y/y earnings gain of 8.1%. At the same point during the Q2-2017 reporting period, a higher percentage of S&P 500 companies (73%) had beaten consensus earnings estimates by a higher 6.1%, and earnings were up a higher 12.1% y/y. On the revenue side, 67% beat sales estimates so far, with results coming in 1.3% above forecast and 5.9% 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 5.6% y/y. Q3 earnings results are higher for 70% of companies, vs 71% at the same point in Q2, and revenues are higher for 79%, vs 80% 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 results are very encouraging. Q3-2017 will mark the fifth straight quarter of positive y/y earnings growth despite the negative impact of the three hurricanes. Y/Y growth fell back into the single digits during Q3 from double-digit percentage growth in H1-2017, which were the first double-digit growth quarters seen since Q3-2011. However, Q3 growth will probably mark a low point, as tax reform should boost growth back into the double digits.

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