**MORNING BRIEFING**
**November 16, 2017**

## Looking a Lot Like Xmas

*See the pdf and the collection of the individual charts linked below.*

(1) Three in a row 3% real GDP. (2) Is the New Normal morphing into the Old Normal? (3) Lots of freight getting hauled on the rails and the roads. (4) Business sales growth is just dandy. (5) Buying retailers on the bad news. (6) Consumers: Solid incomes and manageable debt. (7) Home improvement spending is very strong. (8) Old-fashioned retailers are cheap for a reason. (9) Tesla, solar panels, and batteries electrifying Australia and Puerto Rico.

**US Economy: Rolling Along.** After yesterday's retail sales report, the Atlanta Fed's GDPNow model's forecast for Q4 real GDP was lowered from 3.3% to 3.2%. That's still above 3.0%, as were the actual results for the previous two quarters: up 3.1% during Q2 and 3.0% during Q3. There may be a pattern here, one of quickening economic activity following sluggish growth around 2.0% y/y since mid-2010 (*Fig. 1*). The latest GDPNow estimate implies a 2.6% Q4-to-Q4 growth rate, up from 1.8% last year.

As Debbie and I noted in the 11/7 *Morning Briefing*, since 2010, there has been a tendency for Q1 to be the weakest quarter of the year (*Fig. 2*). It was up only 1.2% this year and 0.6% last year. So the first quarter of next year could provide some more insight on whether the pace of growth is improving if it comes in at 2.0% or more, in our opinion. There are mounting signs of this happening in the weekly and monthly indicators:

(1) *Transportation indicators*. Retailers and other businesses must be expecting a strong holiday season given that both intermodal railcar loadings and trucking tonnage have been soaring to new highs in recent months (*Fig. 3*).

(2) *Business sales.* October retail sales data were released yesterday, as Jackie and I discuss below. Total business sales data were also released for September. Business sales includes manufacturing shipments and distributors' sales. So it includes only goods; all services are excluded. Total business sales soared to new highs both including and excluding petroleum products (*Fig. 4*). It is up 6.4% and 4.8% y/y including and excluding petroleum. Those are solid revenue gains.

**US Retail: Back to the Past?** Retailers reported miserable Q3 results. Actually, that's an understatement. Results were horrific. Most reported negative same-store sales, putting a chunk of blame on the hurricanes and the unseasonably warm fall weather. But a funny thing happened. Despite the awful results, some of the most beleaguered retailers' shares rallied over the past five days through Tuesday even as the S&P 500 declined.

Could it be a sign that the long-suffering industry has hit bottom? Or are investors just expecting a bounce in Q4, presuming that weather trends return to normal? As we've noted before, consumers are healthy and certainly have the ability to spend. They just haven't been spending at brick-and-mortar retailers, particularly the ones that sell clothing.

The S&P 500 Consumer Discretionary sector has risen 13.9% ytd through Tuesday's close, dragged down by the S&P 500 Department Stores (-28.7%), Automotive Retail (-20.5), Apparel Retail (-13.2), and Specialty Stores (-9.8) (*Fig. 5*). But the areas where consumers are spending have performed splendidly, including the S&P 500 Casinos & Gaming index, up 63.3% ytd, Homebuilding (60.7%), Home Improvement Retail (21.5), Auto Parts & Equipment (43.8), Hotels, Resorts, & Cruise Lines (40.3), and Restaurants (19.9) (*Fig. 6* and *Fig. 7*).

However, investors appear to have started bargain-shopping. Over the past week, Department Stores rose 6.1%, Automotive Retail picked up 2.8%, Specialty Stores gained 2.6%, and Apparel Retail added 0.6%, all while the S&P 500 lost -0.5%. I asked Jackie to have a look at whether the shopping spree will continue. Here are her observations:

(1) *Healthy consumers*. With jobs plentiful and debt service manageable, consumers should have plenty of spare change to fund a trip to the mall or the Internet. After a slow grind down from a peak of 10.0% in October 2009, unemployment was down to 4.1% during October (*Fig. 8*).

Meanwhile, household debt levels have returned to their pre-recession highs, though the composition of that debt has changed, with mortgage debt and home equity borrowing down sharply while outstanding student loans and auto loans have moved in the opposite direction (*Fig. 9* and *Fig. 10*). Fortunately, the rise in debt still appears manageable. The household debt service ratio—or the ratio of debt service payments to disposable personal income—is at record lows (*Fig. 11*).

(2) *Money to burn.* The tougher question is: Where will consumers spend their hard-earned cash? Debbie tracks the three-month average of real retail sales, which was up 1.9% (saar) in October (*Fig. 12*). Excluding autos, gasoline, building materials, and food service, retail sales contracted 1.0% (saar) but remain at a very high level, showing signs of life with a 0.5% increase in October.

Consumers certainly have been pouring money into their homes. Retail sales of furniture and home furnishings have returned to prerecession highs. Meanwhile, spending on building materials and garden equipment has hit a new high that exceeds the prerecession levels. Not surprisingly, Home Depot reported strong earnings on Tuesday. Same-store sales in Q3 rose 7.7% in the US, and earnings per share jumped 15.0%, helped by hurricane-related sales. Its shares climbed 1.6% Tuesday, bringing its ytd gain to 25.3%.

Consumers aren't spending in electronics and appliance stores. Nor are they spending in sporting goods, hobby, books, or music stores. The amount being spent at pharmacies and drug stores should be of some concern, as it's near all-time highs. The more consumers spend on drugs, the less they have to spend on trendy clothing. The same can be said about Apple's iPhone X. The amount being spent at non-store retailers, i.e., on the Internet, also poses a problem for traditional retailers. And perhaps that explains why sales at department stores have declined so precipitously in recent years (*Fig. 13* and *Fig. 14*).

Sales at department stores have fallen 31% since 2005; however, they appear to have bottomed at a very low level over the past year. So while Q3 same-store-sales fell 4.0% at Macys and rose only 0.1% at Kohl's, shares of the former jumped more than 12% over the past five trading days and shares of the latter added 3.7%. At Dick's Sporting Goods, Q3 same-store sales dropped 0.9%, but the shares rose 4.9% over the past five trading days.

There's no denying that many of these unloved retail areas are cheap. Earnings for the S&P 500 Department Stores industry is expected to drop 8.6% over the next 12 months, but the industry's forward P/E has fallen to only 9.2, close to the lows of the recession (*Fig. 15* and *Fig. 16*). The forward P/Es of Specialty Stores, 17.3, and Apparel Retail, 15.4, aren't quite as attractive relative to these industries' forward earnings growth rates of 9.6% and 6.0%.

While there's no guarantee that the one-week rotation into unloved areas of retail will continue, a Q4 rebound from a miserable Q3 would certainly make a nice holiday present.

**Batteries: Charging Ahead.** Most of the ink that is spilt on Tesla concerns the company's battery-powered cars. But the company also sells batteries for grid energy storage, and, thanks to the company's 2016 acquisition of SolarCity, it is a major producer of solar panels. This year, Tesla has had an opportunity to show off its non-auto capabilities by helping two nations with power problems: Australia and Puerto Rico. While the situation in each country is unique, both provide a wider picture of Tesla's product offerings and how electric generation and storage may change in the future. Here's Jackie's report on this disruptive technology:

(1) *Energy Down Under*. In Australia. they call it the "Climate Wars." The country, which is largely dependent on coal-fired electric plants, has had a rocky experience trying to go green. Coal is used to produce 60% of Australia's energy, down from 80% a decade ago. The nation had made a big push to use more renewable energy and shut down coal-fired electric plants. South Australia and Queensland aimed to get half of their electricity from renewable sources, with gas-powered plants used as a backup.

But then in February, a blackout hit 90,000 homes in Southern Australia in the midst of a heat wave. "As temperatures rose above 105 degrees Fahrenheit, a local power plant couldn't get enough gas to meet the additional demand, and sources such as wind and solar couldn't fill the gap," a 10/17 *WSJ* article reported. The inability to access natural gas in Australia is ironic since the country is one of the largest exporters of liquefied natural gas, or LNG. "In the week that Adelaide's February blackout cut power to 90,000 homes, five ships left Gladstone carrying out 314,000 tons of LNG altogether, according to the port operator. That's enough to generate electricity for roughly 750,000 Australian homes for a year, according to calculations for the Journal by the Australian Bureau of Statistics," a 7/10 *WSJ* article noted.

The February blackout wasn't an isolated event. "In March, Australia's largest aluminum smelter cut production and laid off workers because it said it couldn't secure enough cheap energy. During one blackout last year, some families lost embryos in an in-vitro-fertilization clinic with no backup generation, according to a government-commissioned report. In February, some tuna fishermen watched catches rot because freezers shut off," the 7/10 *WSJ* reported. In addition to poor service, Australia's electricity is among the most expensive in the world.

Since the blackout, more natural gas has been retained in Australia, and more land has been made available for drilling for gas. In addition, Tesla agreed to build the world's largest lithium-ion battery system. The 100-megawatt system stores energy from a wind farm. Elon Musk offered to build the battery installation in 100 days or deliver it for free. The clock started on September 29, when a grid agreement was signed, DailyMail.com reported on 10/2. South Australia is counting on the storage capacity to be in place by December, when summer's hot temperatures mean electricity demand surges. Tesla will either enjoy a PR coup or face a PR disaster.

(2) *Caribbean sunshine*. Hurricane Maria wiped out Puerto Rico's electric grid on September 20, and not much has been done to repair it since. As of November 9, the country's only utility, Prepa, has brought a little more than 40% of its generating capacity back online, according to an 11/11 article in Quartz. Prepa was in bankruptcy protection prior to the storm and generates more than 40% of its electricity using oil-fueled generators. The lack of infrastructure and perpetually sunny skies could make Puerto Rico a prime candidate for the mass adoption of solar power.

The Quartz article explains, "Solar power companies are moving just as quickly to set up micro-grids: local power systems with battery storage, which can operate independently from the main grid. Houston-based Sunnova, which already has some 10,000 customers with solar panels on the island, is sending them batteries. Tesla switched power back on at the children's hospital in San Juan, 'the first of many solar+storage projects' in the island, the company tweeted. Sonnen, a German manufacturer of solar energy-storage equipment, has also donated 15 micro-grids. Such setups could help ease the power shortages while Prepa is still busy rehanging power lines, but once the grid is back up they'll also serve to eat away at its monopoly on generation."

Not everyone is in the solar camp. Some contend that Puerto Rico should build an LNG terminal and use natural gas to power more of its electric plants. However, by the time a decision to do so could be made and facilities built, solar panels might already be supplying much of the country's electricity.

## CALENDARS

**US. Thurs:** Jobless Claims 235k, Headline & Manufacturing Industrial Production 0.5%/0.3%, Capacity Utilization 76.3%, Philadelphia Fed Manufacturing Index 25.0, Import & Export Prices 0.4%/0.1%, Housing Market Index 67, Weekly Consumer Comfort Index, EIA Natural Gas Report, Kaplan, Brainard. **Fri:** Housing Starts & Building Permits 1.190mu/1.250mu, Kansas City Manufacturing Index 23, E-Commerce Retail Sales, Baker-Hughes Rig Count. (*Wall Street Journal* estimates)

**Global. Thurs:** Eurozone Headline & Core CPI 1.4%/0.9% y/y, UK Retail Sales Including & Excluding Auto Fuel -0.5%/-0.4% y/y, Australia Employment Change & Unemployment Rate 18.8k/5.5%, Carney. **Fri:** Canada CPI 0.1%m/m/1.4%y/y, Draghi. (DailyFX estimates)

## STRATEGY INDICATORS

**Stock Market Sentiment Indicators** (*link*): Our Bull/Bear Ratio (BBR) fell to 4.12 this week after climbing seven of the prior eight weeks from 2.33 to 4.47—which was the highest reading March 1987! Bullish sentiment slipped to 63.5% after increasing steadily the previous eight weeks from an 11-month low of 47.1% to 64.4%—which was just shy of its high of 64.9% posted in early 1987. (It was the sixth straight reading of 60.0% or above.) The correction count fell in eight of the past nine weeks from 32.7% to 21.1%—near its low for the year of 20.4% during the final week of February. Bearish sentiment climbed to 15.4% this week from 14.4% the prior two weeks—which was the fewest bears since early May 2015. This is the sixth straight week with the bears below the narrow 16.5%-18.3% range that held for most of this year, and may be setting a new, lower range. The AAII Ratio climbed for the second week last week to 66.1% after sinking the prior two weeks from 59.7% to 54.5%. Bullish sentiment rose from 39.6% to 45.1% over the two-week period, while bearish sentiment fell from 33.0% to 23.1%.

**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 has been steady for four weeks 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 edged 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 rose to 11.1% from 11.0%, but is down from a nine-month high of 11.5% in mid-October. 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 Consumer Staples, 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 10.1% is 1.0ppts 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 rose to 18.2 from 18.0, and is now the highest since January 2004 and up from a 15-month low of 14.9 in January 2016. The S&P 500 price-to-sales ratio rose to a record high of 2.02, and remained steady at a record high of 2.08 on an ex-Energy basis. On an ex-Energy basis, the forward P/E of 17.8 remains the highest since February 2004.

**S&P 500 Sectors Earnings, Revenues & Valuation** (*link*): Consensus forward revenue forecasts rose last week for 7/11 sectors, but forward earnings rose for only three sectors. Energy and Tech were the only sectors to have both measures improve 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. Forward P/E ratios remain near cyclical highs for all sectors except Energy, Health Care, and Telecom. Energy's forward revenues and earnings are improving from cyclical lows in early 2016, but its valuations remain elevated; its P/S ratio of 1.36 compares to a record high of 1.56 in May 2016, and its P/E of 26.5 is down from a record high of 57.5 then. Higher y/y margins are expected in 2017 for all but Industrials, Real Estate, Telecom, and Utilities. In the latest week, the forecasted forward profit margin edged up 0.1ppt for Energy and Real Estate, but tumbled 0.5ppts for Telecom. Here's how they rank based on their current forward profit margin forecasts: Information Technology (21.0%), Real Estate (17.1), Financials (16.4), Telecom (11.2), Utilities (11.4), S&P 500 (11.1), Health Care (10.7), Materials (10.6), Industrials (9.2), Consumer Discretionary (7.6), Consumer Staples (6.8), and Energy (5.1).

## US ECONOMIC INDICATORS

**Retail Sales** (*link*): October retail sales unexpectedly rose to a new record high, while September's rebound was stronger than first reported. Sales rose for the third time in four months, up 0.2% m/m and 2.5% over the period. September's advance was revised up to 1.9% from the initial estimate of 1.6%, which reflected a hurricane-related surge in motor vehicle, gasoline, and building materials spending. Core retail sales hasn't posted a decline in five months, climbing 0.3% in October and 1.6% the past four months. (BEA uses this core retail sales measure to estimate personal consumption expenditures each month.) Meanwhile, we estimate real retail sales advanced 0.4% last month following a 0.7% gain in September and a 0.6% loss in August—which was only the second decline this year. These sales expanded 1.9% (saar) during the three months through October, based on the three-month average, slowing steadily from July's 5.9%. Real core retail sales rebounded 0.5% in October after a two-month slide of 1.1%—which was the first back-to-back loss since fall 2012. Its comparable three-month growth rate contracted 1.0% (saar), slowing from June's 7.8%. Eight of the 13 major nominal retail sales categories rose in October, three fell, while general merchandise and miscellaneous store retailers showed no growth. Leading October's gain was a 1.5% jump in sales at sporting goods, hobby, book & music stores, while motor vehicle, furniture, food & beverage, health & personal care, food services & drinking, and clothing retailers posted gains from 0.7% to 0.8%. Building materials and gasoline services station sales both sank 1.2%, unwinding the boost from the recent hurricanes; nonstore retailer saw sales slip 0.3% after rising two of the prior three months by 1.8%.

**Business Sales & Inventories** (*link*): Nominal business sales in September and real sales in August both reached new record highs. The details: Nominal manufacturing & trade sales (MTS) have only posted one decline the past 14 months, rising 1.4% in September and 7.2% over the period. Inflation-adjusted MTS rebounded 1.6% in the four months through August after slumping 1.0% the first four months of the year. Real sales of wholesalers climbed to another new record high in August, while retailers' was little changed around July's record high; manufacturers' sales continued to move back toward December's cyclical peak. August's real inventories-to-sales ratio was at 1.43 for the fourth month, matching December's reading, which was the lowest since January 2015; it was at a cyclical high of 1.47 in May 2016. August's nominal inventories-to-sales ratio sank to 1.36 from 1.38 the prior three months, its lowest reading since December 2014; it had peaked at 1.42 during the first four months of 2016.

**Regional M-PMI** (*link*): The New York Fed district, the first to report on manufacturing, showed activity remained firmly in positive territory this month though eased from October's three-year high. The composite index slipped 10.8 points to 19.4 from 30.2 in October, which was its best reading since September 2014. This month's report showed shipments (to 18.4 from 27.5) decelerated while new orders (to 20.7 from 18.0) accelerated, though both pointed to ongoing solid gains in both. Delivery times (-2,3 from 3.1) were shorter than October, while inventory levels (4.6 from -7.8) were higher. As for labor conditions, the employment (11.5 from 15.6) measure showed hirings expanded at a somewhat slower pace than October, while the average workweek (-0.8 from 0.0) held fairly steady. Both input and output prices increased at about the same pace as last month. Looking ahead, firms were very optimistic about the sixth-month outlook, with the future business conditions index (49.9 from 44.8) reaching its highest reading since January 2012.

## GLOBAL ECONOMIC INDICATORS

**World CPI** (*link*): Global consumer inflation has bounced around 3.0% y/y through the first nine months of this year, ticking up from 2.9% to 3.0% in September. Before its recent move up, global inflation was on a disinflationary trend, falling from 5.2% in September 2011 to a recent low of 2.4% in August 2016. The inflation rates for advanced and emerging economies are converging. The CPI rate for advanced economies was at 2.0% y/y in September, up from its recent low of 0.1% in September 2015. Inflation in the emerging economies has been on a fairly steady disinflationary trend since peaking at 10.6% in July 2008; it was down at 2.1% this August.

**US CPI** (*link*): The core CPI rate in October ticked up to 1.8% y/y from 1.7% the prior four months, below the Fed's target rate of 2.0% y/y for the seventh month, after 15 months above—ranging from 2.1% to 2.3%—from December 2015 through February of this year. The three-month rate accelerated for the fifth month to 2.4% (saar) after no change in May, which was the lowest reading in seven years. On a monthly basis, core prices rose 0.2% for the second time in three months after a string of 0.1% gains. Among the indexes posting gains last month were shelter, medical care, used cars & trucks, tobacco, education, motor vehicle insurance, and personal care, partially offset by lower prices for new vehicles, recreation, and apparel. The headline CPI edged up only 0.1% after gains of 0.5% and 0.4% the prior two months. The yearly rate eased to 2.0% after climbing the prior three months from 1.6% to 2.2%.

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