MORNING BRIEFING
November 21, 2017

Thanksgiving

Happy Thanksgiving! We will be back on Monday, November 27.

See the collection of the individual charts linked below.

(1) Thanks to family, friends, and others. (2) Next stop for S&P 500: 4 x 666, then 5 x 666. (3) Second best bull market since 1928. (4) Raising S&P 500 target for mid-2018 to 2700-2800. (5) Tax cuts could trigger meltup. (6) Oh no! FY 2017 federal deficit was $666 billion. (7) Federal government outlays at record high, led by spending on redistributing income. (8) Tax receipts flatten despite strong payroll tax receipts. (9) Actual corporate tax receipts suggest even lower effective tax rate. (10) Leading indicators pointing higher for economy.

Holiday Season: Giving Thanks. This is the time of year we all give thanks to our families for being there for us. We thank our friends for being our friends. We should give thanks to the men and women serving our country as first responders and in the military. We should thank our nation's Founders for our political system of checks and balances. And of course, we at Yardeni Research thank you for your loyal support of our research service. We wish you all the very best of times with your family and friends during Thanksgiving.

Strategy: Devilish Bull Market. I would also like to thank Ron Howard and Tom Hanks. The former directed "The Da Vinci Code" (2006), and the latter starred in the film as Robert Langdon, a professor of religious iconography and symbology from Harvard University. It was during March 2009 that I morphed from being an investment strategist to being a symbologist. Back then, I was struck by the fact that the S&P 500 made an intraday low of 666 on March 6, 2009. I concluded that we had gone to Hades and would scramble to get the hello out of there.

The number 666 is associated with the Devil. After bottoming at that devilish number, the S&P 500 proceeded to double from there to 1332 by February 14, 2011, and triple from there to 1998 by August 26, 2014. If it quadruples from there, the S&P 500 would rise to 2664. That's only 3.3% above Friday's close (*Fig. 1*). If it gets there, the S&P 500 would be up 300% from the 666 low. It is already the second best bull market since 1928, only bested by the 582% gain from December 4, 1987 to March 24, 2000.

There are no devils in the details of getting to 2664 on the S&P 500. The forward earnings of this index rose to a record high of $144.29 during the week of November 16 (*Fig. 2*). The index's forward P/E was 17.9 that week (*Fig. 3*). Those two numbers put the S&P 500 at 2579. Getting to 2664 would require only a minor increase in the S&P 500 forward P/E.

Given that the holiday season is ahead, Joe and I are already in a festive mood. We are raising our mid-2018 S&P 500 target from 2600-2700 to 2700-2800. The top end of this range is about 8% above the current S&P 500. If the multiple stays at 18.0, the forward earnings would have to rise to $155.67 by mid-2018. That's realistic given that industry analysts are currently projecting $160.21 by the end of next year.

If the S&P 500 blows through 2700 and then 2800 by the end of this year or early next year with the forward P/E surpassing 20.0, we will be in a meltup most likely triggered by the passage of tax cuts before the end of this year.

US Economy I: Devilish Deficit. There is another devilish number out there. Once again, it is 666. The fiscal 2017 federal budget deficit reached $666 billion during the 12 months through September, before widening to $683 billion in October (*Fig. 4*). The 12-month sum of federal outlays rose to a record $4.0 trillion in October, while receipts have been relatively flat around $3.3 trillion since early 2016 (*Fig. 5*). What's boosting outlays and weighing on receipts? Let's have a closer look:

(1) *Outlays.* Federal outlays on goods and services, as measured in the GDP accounts, has been remarkably flat around $1.3 trillion since the start of the current economic expansion during 2009 (*Fig. 6*). The same cannot be said for federal spending on redistributing income. The sum of such outlays on Medicaid, Medicare, Income Security, and Social Security rose $828 billion since the start of 2009 to a record $2.6 trillion during the 12 months through October of this year.

Federal government outlays on redistributing income now account for 65% of total federal government outlays, up from 43% in early 1987 (*Fig. 7*).

(2) *Receipts.* Federal government revenues have flattened out over the past year as individual income tax receipts slowed, while corporate tax receipts declined slightly (*Fig. 8*). On the other hand, payroll taxes rose to a record high of $1.2 trillion over the past 12 months through October.

By the way, there seems to be a fairly large discrepancy between the National Income and Product Accounts (NIPA) measure of corporate taxes and the taxes actually collected by the IRS (*Fig. 9*). During Q2-2017, the NIPA number was $479.6 billion (based on the four-quarter average of the saar data), while the 12-month sum (through June) of the Treasury's data showed $299.4 billion. This implies that the effective tax rate paid by corporations is even lower than the 21.3% shown during Q2-2017 in NIPA and well below the statutory rate (*Fig. 10*). We calculate that it was 13.3% during Q2-2017 based on the corporate tax receipts actually received by the IRS over the prior four quarters.

Could it be that Congress is about to cut the statutory corporate tax rate from 35% to 20%, which will amount to an effective tax increase on corporations? That's what the data show!

(3) *Deficit*. It's a wee bit unnerving to see that the federal deficit was $666 billion over the past fiscal year. I'm not concerned about that as a symbologist but rather as an investment strategist. Over the past year, the economy has performed very well, with the unemployment rate falling to a cyclical low of 4.1% during October. Arguably, the economy is at full employment. So why are we still running such a huge deficit? Now multiply that number by 10 years and add $1.5 trillion to this deficit if the GOP tax cuts are enacted. The result is another $8 trillion in federal government debt on top of the current $14 trillion. If interest rates ever go up again, watch how fast the debt will compound.

US Economy II: Leading Higher. Let's be thankful that the Index of Leading Economic Indicators rose 1.2% m/m during October to a new record high (*Fig. 11*). It is leading the way for the Index of Coincident Economic Indicators (CEI), which rose to another record high last month, as Debbie discusses below. The latter is up 1.9% y/y, confirming that the growth rate in real GDP on a y/y basis is still running around 2% (*Fig. 12*).

It was back in 2014 that Debbie and I concluded that based on the past five cycles in the CEI, the next recession wouldn't happen until 2019 (*Fig. 13*). That wasn't a forecast. It was a benchmark based on the average length of expansion periods following the recovery back to the previous high in the CEI.

The past five post-recovery expansion periods lasted from 30 months to 104 months, averaging 65 months. The CEI rose to a new record high for the first time during the current expansion during February 2014, according to the most recent data. Add 65 months, and the next recession won't start until July 2019 according to the benchmark model.

Stock investors seem to have come to a similar conclusion recently, namely that the economy has time to keep growing before the next recession hits. Meanwhile, our Weekly Leading Index remains in record-high territory, and bullish for stocks (*Fig. 14*).

CALENDARS

US. Tues: Existing Home Sales 5.425mu, Chicago Fed National Activity Index 0.20, Yellen. **Wed:** Durable Goods Orders Total, Ex Transportation, and Core Capital Goods 0.4%/0.5%/0.5%, Consumer Sentiment Index 98.1, Jobless Claims 240k, Weekly Consumer Comfort Index, MBA Mortgage Applications, EIA Petroleum Status Report, EIA Natural Gas Report, FOMC Minutes. **Thurs:** None. **Fri:** Composite, Manufacturing , and Nonmanufacturing PMIs 55.4/54.5/55.4, Baker-Hughes Rig Count. (*Wall Street Journal* estimates)

Global. Tues: RBA November Meeting Minutes, Lowe. **Wed:** Eurozone Consumer Confidence -0.9, UK Chancellor Presents Budget to Parliament. **Thurs:** Eurozone, Germany, and France C-PMI Flash Estimates 55.9/56.7/57.2, Eurozone, Germany, and France M-PMI Flash Estimates 58.2/60.3/55.9, Eurozone, Germany, and France NM-PMI Flash Estimates 55.2/55.0/57.0, Germany GDP 0.8%q/q/2.8%y/y, UK GDP 0.4%q/q/1.5%y/y, Canada Retail Sales 1.0%, ECM Account of Monetary Policy Meeting. **Fri:** Germany IFO Business Climate, Current Assessment, and Expectations Indexes 116.5/125.0/108.8, Japan M-PMI Flash Estimate. (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—has taken a step back since reaching a new record high during the final week of October. Our WLI sank 1.7% during the week of November 11 after a 0.1% downtick the prior week—only 1.8% below its record high. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). Our BBB dropped 3.3% over the two-week period, after a five-week jump of 16.3% to a new record high, as jobless claims moved higher after unwinding its hurricane-related jump. Jobless claims rose for the first time in seven weeks to 237,750 (4-wa) after falling the previous six weeks from 277,000 to 231,250—which was the lowest reading since March 1973. Meanwhile, the CRB raw industrial spot price index—another BBB component—continues to move sideways around recent lows as 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 LargeCap and MidCap, but SmallCap was down for the first time in 13 weeks to 0.3% below its record. LargeCap's forward earnings was higher for a 17th straight week and MidCap's for a 13th 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 edged down to 10.2% y/y from a 70-month high of 10.3%, which compares to a six-year low of -1.8% in October 2015; MidCap's rose to a 71-month high of 15.3% from 15.1%, which compares to a six-year low of -1.3% in December 2015; and SmallCap's dropped to 10.9% from a 14-week high of 11.3%, 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 11.3% and 11.1%, MidCap 10.5% and 14.1%, and SmallCap 5.4% and 19.9%.

S&P 500/400/600 Forward Valuation (*link*): Forward P/E ratios for the three indexes mostly edged higher last week. LargeCap's weekly forward P/E was steady w/w at 17.9, a shade below late October's 18.0 reading, 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 meltup, but has been rising again recently. MidCap's forward P/E rose to 18.2 from 18.0, but remains close to the 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 rose to 19.7 from an eight-week low of 19.4, 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 1.30 is down from a record high of 1.39 in early March, and SmallCap's 1.02 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 nearly 95% complete, Q4 earnings revisions activity has slowed considerably. The S&P 500's Q4-2017 EPS forecast dropped 4 cents w/w to $34.73, and is down only 0.7% from $34.98 at the end of Q3. The $34.73 estimate represents a forecasted pro forma earnings gain for Q4-2017 of 11.5%, up from 11.4% a week earlier and compared to Q3-2017's blended estimate/actual of 8.2%, 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 three sectors, lower for seven, and steady for one. Energy's Q4 forecast has risen 15.3% followed by these sectors: Utilities (up 2.4%), Tech (1.9), and Telecom (0.0). Materials' Q4-2017 forecast has fallen 9.6% for the worst decline, and is followed by: Industrials (-9.3), Real Estate (-6.6), Consumer Discretionary (-5.1), Health Care (-2.2), Financials (-1.7), and Consumer Staples (-1.1). The S&P 500's Q4-2017 forecasted earnings gain of 11.5% 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 11.5%. 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 (115.4% in Q4 vs. 161.0% in Q3), Materials (25.5, 7.0), Financials (14.3, -7.3), Tech (14.3, 23.7), S&P 500 (11.5, 8.2), Utilities (9.4, -4.6), Consumer Staples (8.5, 4.6), Consumer Discretionary (6.0, 3.7), Health Care (4.9, 8.0), Industrials (4.0, 2.9), Real Estate (-0.8, 3.8), and Telecom (-1.8, -2.8). On an ex-Energy basis, S&P 500 earnings are expected to rise 9.4% y/y in Q4, up from 5.9% 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 94% of S&P 500 companies finished reporting Q3-2017 results through midday Monday, their earnings surprise figures are a tad weaker compared to the same point during the Q2 earnings season, but their revenue metrics have improved. Of the 473 companies in the S&P 500 that have reported, 73% exceeded industry analysts' earnings estimates, by an average of 5.4%; they have averaged a y/y earnings gain of 8.1%. At the same point during the Q2-2017 reporting period, a similar percentage of S&P 500 companies (73%) had beaten consensus earnings estimates by a higher 5.6%, and earnings were up a higher 11.7% y/y. On the revenue side, 68% 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 similar 68% had exceeded revenue forecasts by a lower 1.0%, and sales rose a lower 5.2% y/y. Q3 earnings results are higher for 69% of companies, vs 70% at the same point in Q2, and revenues are higher for 79%, vs 79% a quarter ago. Q3-2017 marks the fifth straight quarter of positive y/y earnings growth despite the negative impact of the three hurricanes on earnings. Y/Y earnings 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 earnings growth will probably mark a low point, as tax reform should boost growth back into the double digits.

US ECONOMIC INDICATORS

Leading Indicators (*link*): Leading indicators in October blew past forecasts to yet another new record high, posting its 14th consecutive increase. “The US LEI increased sharply in October, as the impact of the hurricanes dissipated," according to The Conference Board. "The growth of the LEI, coupled with widespread strengths among its components, suggests that solid growth in the US economy will continue through the holiday season and into the new year.” The Leading Indicators Index (LEI) jumped 1.2% last month, the largest advance since November 2013 and double consensus expectations, while September’s 0.2% loss was revised upward to show a 0.1% gain. All but one of the 10 components of the LEI contributed positively last month, led by jobless claims (0.45ppt)—with sizable contributions also coming from building permits (0.17), the new orders diffusion index (0.16), consumer expectations (0.14), the interest-rate spread (0.14), and stock prices (0.10). The remaining components—the average workweek, leading credit index, and real consumer goods orders—contributed from 0.02-0.07ppt, while real core capital goods orders (-0.03) was the one outlier, causing only a minor drag.

Coincident Indicators (*link*): October’s Coincident Indicators Index (CEI) climbed 0.3% to another new record high. Over the past 19 months, the CEI has posted only one decline—advancing 3.2% over the period. All four components contributed positively last month: 1) Industrial production more than reversed its recent hurricane-related drop, rebounding 0.9% last month, and 1.3% the past two months, to its highest reading since the end of 2014. 2) Nonfarm payroll employment continued to head straight up to new record highs in October—not posting a decline since September 2010—as September’s preliminary estimate of a 33,000 decrease was revised to an 18,000 increase. 3) Real personal income—excluding transfer payments—rose 0.2% in October, and 2.4% ytd, after falling the last five months of 2016. 4) Real manufacturing & trade sales rebounded 2.1% in the six months through October—setting new record highs along the way.

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