Yardeni Research, Inc.

MORNING BRIEFING
November 30, 2017

Taxing & Shopping Matters

See the collection of the individual charts linked below.

(1) Theories, urban legends, opinions, fake news, and facts. (2) Is the corporate tax rate currently 35%, 21%, or 13%? (3) Corporate tax reform may be about eliminating foreign tax dodges rather than cutting taxes. (4) 'Tis the season for retailers. (5) Thor Industries makes RVs that are selling like hotcakes, confirming strong consumer trends. (6) 2018 is coming: Another double-digit year for earnings?

Corporate Taxes: Facts vs Fiction. In the realm of economics, there are lots of theories. There are also lots of urban legends. Both are often propagated despite lots of facts that question their credibility. Daniel Patrick Moynihan, the former senator from New York, once said, "Everyone is entitled to his own opinion, but not to his own facts." In today's world of "fake news," sorting out fact from fiction is a challenge. In the realm of economics, there's no shortage of data, which can be very helpful in discerning the difference between information and disinformation.

Which brings me to the subject of the US corporate tax rate, which Republicans are aiming to cut. The widespread view, especially among Republicans, is that the corporate tax rate is too high. They aim to pass a tax reform package before the end of the year that will lower the statutory rate from 35% to 20%. I'm all for tax cuts. However, I'm having a problem with the data:

(1) *GDP data.* Yesterday's GDP release for Q3 included corporate pretax and after-tax corporate profits. The data show that corporations paid $472.9 billion in taxes over the past four quarters through Q3 (*Fig. 1*). This series has been hovering in record-high territory around $500 billion since Q2-2014.

Dividing this tax series by pretax profits of $2281.4 billion over this same period shows that the effective tax rate has been significantly below the statutory rate since the start of the previous decade (*Fig. 2*). During Q3, it was only 20.7%!

(2) *Treasury data.* But wait … the plot thickens: Actual corporate tax revenues collected by the IRS have been consistently less than the corporate taxes included in the GDP measure of corporate profits since the start of the former data series in 1972 (*Fig. 3*). For example, over the past four quarters through Q3, the Treasury reported collecting $297.0 billion in corporate tax revenues, 37% less than the $472.9 billion shown by the GDP measure, on a comparable basis.

The shocking result is that the effective corporate tax rate based on actual tax collections was only 13.0% during Q3, and has been mostly well below 20.0% since the start of the previous decade (*Fig. 4*).

What gives? Which one of the data series is fake news? Melissa and I are still investigating. However, we would follow the money, which tends to support the story told by the IRS data. If so, then Congress may be about to cut a tax that doesn't need cutting. Or else, the congressional plan is actually reform aiming to stop US companies from using overseas tax dodges by giving them a lower statutory rate at home. We may not be able to see the devil in the details of the bill until it is actually enacted.

Retailing I: Happy Holidays. The retailing industry is wrapping up a miserable year with a bow. Retail stocks have outperformed the broader market since mid-November as consumers rushed through their Thanksgiving meals to go shopping both online and in stores.

The S&P 500 Consumer Discretionary sector is up 3.1% since November 14 through Tuesday's close, besting the S&P 500's return of 1.9% and beaten by only Telecom. Here's the performance derby among S&P 500 sectors over this period: Telecom (7.1%), Consumer Discretionary (3.1), Financials (2.9), Industrials (2.7), Materials (2.2), S&P 500 (1.9), Tech (1.7), Health Care (1.7), Consumer Staples (0.9), Energy (-0.8), Utilities (-1.2), and Real Estate (-1.3) (*Table 1*).

The outperformance by S&P 500 industries in the retailing business is even more dramatic over the same time period. Apparel Retail (10.2%), Department Stores (10.2), Housewares & Specialties (9.8), Food Retail (7.0), Footwear (6.4), and Apparel, Accessories & Luxury goods (5.2) all are among the 15 best-performing S&P 500 industries we track (*Fig. 5*). These industries even outperformed Amazon, which rose 5.0% over the same period.

In the wake of a strong Black Friday, the National Retail Federation predicts sales for November and December will rise 4% compared to last year. If that estimate comes through, this will be the strongest holiday sales season since 2014, an 11/25 *WSJ* article reported. Bloomberg gave credit to the older Millennials, who were the biggest spenders over the holiday weekend. "Older millennials shelled out $419.52 during the five-day stretch, 25 percent more than the overall average," its 11/28 article noted.

Retailing II: RVs on the Road Again. More positive news about the consumer arrived Monday night when RV manufacturer Thor Industries reported sales that soared past Wall Street analysts' estimates. Fiscal Q1 sales rose 30.6%, and net income jumped 63.1%. Diluted EPS also rose 63.1%, to $2.43, beating Wall Street's $1.84 estimate. As importantly, the company's backlog of orders rose 69.9% to $3.58 billion. The following day, the shares gained 13.3%, or $18.12, to $154.37. We don't recommend individual stocks, but Thor's story provides a good insight into the economy:

(1) *General economic conditions are good.* Thor attributed its strong quarter to "positive employment, wage trends, and general economic conditions," according to its press release. It also believes the overall demand for RVs is growing as new consumers adopt the RV "lifestyle." It did not attribute the surge in sales to the recent hurricanes or forest fires, noting that its backlogs were already at record levels before the natural disasters.

(2) *Planning to expand capacity*. In response to strong demand, Thor has been expanding its manufacturing plants and in June 2016 acquired Jayco Corp. for $576 million. The company plans further expansion in fiscal 2018, with capital spending rising to $185 million, up from $115 million in fiscal 2017.

(3) *Consumers are credit worthy.* The company doesn't do a Q&A with analysts, but offers up a number of questions and answers that it compiles, which provide an interesting read on the economy. Thor noted that credit is available to buyers: "Retail lending standards are also healthy and credit is broadly available to credit-worthy consumers with reasonable down payments and normal length of term options available. The retail RV delinquency rate remains below 1% and is significantly below the average delinquency rate of closed-end consumer loans."

(4) *Labor market is tight, and pricing power is limited.* Thor also noted that the labor market is "tight" in Northern Indiana, and the company therefore has expanded into other areas, including Idaho. It has seen "modest" cost increases in certain raw materials, reflecting either a rising price in the underlying commodity or other inputs like labor. However, beyond passing on any increase in input costs, the

company feels it has limited pricing power because of competition both from others in the industry and those vying for consumers' discretionary spending dollars generally.

(5) *Outlook is bright*. Although the current expansion is the longest in the RV industry's history, Thor remains optimistic that the good times will continue to roll as new consumers enter the market. In addition, it sees continued growth coming from "improving personal income, higher home values, increasing stock prices driving higher personal wealth, continued strength in light truck and sport utility vehicle sales, and the future potential for tax reform that may provide a boost to consumers. In addition, the demographics are as favorable as they have ever been for our industry, and all indicators are that they will remain so for the foreseeable future." Sound like items that should benefit investors in the broader markets as well.

(6) *Performance is great.* The S&P 400 Automobile Manufacturers industry, whose sole member is Thor, has roared higher by 54.3% ytd (*Fig. 6*). The industry is expected to grow revenue by 9.3% over the next 12 months and increase earnings by 13.9%. As long as the cycle continues, it has a reasonable P/E of 16.1.

Earnings: 2018 Is Coming Soon! December 1 used to be when we'd start shopping for a new calendar for the upcoming year. That was, of course, before the iPhone became the center of our lives and eliminated the need for something so yesterday. But calendars are still a big business. Sales of decorative and other calendars increased by 8% in 2016 to $65 million, according to a 12/29/16 *NYT* article.

The start of December is still a good time to take a look at the sales and earnings growth Wall Street's analysts are expecting from S&P 500 companies in the upcoming year. Optimism about future results abounds, even as comparisons to a stellar 2017 are tough. Sales growth is anticipated to slow ever so slightly to 5.5% in 2018 from 6.1% this year. Conversely, earnings growth is estimated to accelerate ever so slightly to 11.4% in 2018 from 10.9% this year.

As is often the case, earnings of the sectors underlying the S&P 500 rarely perform in lock step with the overall index, with some expected to be far stronger and others far weaker. Here's a quick look at which S&P 500 sectors are expected to pick up steam next year and which are expected to lose it:

(1) *Accelerating prospects*. Consumers are expected to keep doing what they do best: shop. Earnings growth in the Consumer Discretionary sector is anticipated to pick up to 9.1% in 2018 from 5.9% this year. Likewise, higher interest rates and less regulation are projected to finally help the Financials. That sector is expected to grow earnings by 15.6% next year, almost double the 8.7% forecasted for this year. Analysts are also penciling in nice bounces in earnings for Industrials and Materials. Industrials' earnings are projected to rise to 9.4% in 2018, well above the 3.4% growth expected this year, while Materials' earnings are expected to rise 18.5% in 2018 versus 13.3% in 2017.

(2) *Growing, but slower*. It would be tough for the Energy sector to replicate in 2018 the 355.9% earnings growth expected this year as the sector was coming off a depressed 2016. But analysts do see the sector continuing to rebound in 2018, with earnings projected to grow 37.9%. That growth has been revised upwards by 5% over the past month. The Technology sector's torrid earnings growth of 16.8% this year is forecast to slow to 13.8% in 2018.

(3) *Losers still*. The only two sectors that are on course to post earnings declines in 2017—Real Estate and Telecom—are expected to post losses once again next year. The Real Estate sector is expected to see a 15.8% decline in earnings this year followed by a 9.7% drop in 2018. Telecom should see its bottom line contract 2.0% this year, then 0.3% next.

(4) *Round up*. While these are early days, and expectations are bound to change, it's always good to know where you're starting when plotting where you're headed. In that vein, here's the performance derby for S&P 500 sector earnings growth in 2018 from best to worst: Energy (37.9%), Materials (18.5), Financials (15.6), Tech (13.8), S&P 500 (11.4), Industrials (9.4), Consumer Discretionary (9.1), Consumer Staples (7.7), Health Care (6.8), Utilities (4.7), Telecom (-0.3), and Real Estate (-9.7).

CALENDARS

US. Thurs: Personal Income & Consumption 0.3%/0.3%, Headline & Core PCED 1.5%/1.4% y/y, Jobless Claims 240k, Chicago PMI 63.5, Weekly Consumer Comfort Index, EIA Natural Gas Report, Kaplan. **Fri:** Total & Domestic Motor Vehicle Sales 17.6mu/13.7mu, Construction Spending 0.5%, ISM & Markit M-PMIs 58.4/54.5, Baker Hughes Rig Count, Kaplan, Harker. (*Wall Street Journal* estimates)

Global. Thurs: Eurozone CPI Headline & Core Flash Estimate 1.6%/1.0% y/y, Eurozone Unemployment Rate 8.9%, Germany Unemployment Change & Unemployment Claims Rate -10k/5.6%, Germany Retail Sales 0.3%m/m/2.8%y/y, Japan CPI Headline, Core, and Core-Core 0.2%/0.8%/0.2% y/y, Japan Jobless Rate 2.8%, Japan Household Spending -0.3% y/y, Japan Housing Starts 950k, China M-PMI 51.5. **Fri:** Eurozone, Germany, France, and Italy M-PMIs 60.0/62.5/57.5/58.3, Italy GDP 0.5%q/q/1.8%y/y, UK M-PMI 56.5, Canada GDP 1.6%q/q/3.3%y/y, Canada Employment Change & Unemployment Rate 10k/6.2%, China Markit/Caixin M-PMI 51.0. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): Our Bull/Bear Ratio (BBR) edged up from 3.99 to 4.13 this week, the sixth time in the past eight weeks the reading was 4.00 or higher. It reached 4.47 three weeks ago, which was the highest reading since March 1987! Bullish sentiment has been at 60.0% or above for the past eight weeks, edging up from 61.5% to 62.3% this week, near this year's high of 64.4%—which was just shy of its high of 64.9% posted in early 1987. It was as low as 47.1% 11 weeks ago. The correction count fell in nine of the past 11 weeks from 32.7% to 22.6%—near its low for the year of 20.4% during the final week of February. Bearish sentiment posted a small decline this week to 15.1% after two weeks at 15.4%; it began November at 14.4%, which was the fewest bulls since May 2015. The AAII Ratio climbed to 55.0% last week after falling the prior week from 66.1% to 45.5%. Bullish sentiment rose from 29.4% to 35.5% last week, while bearish sentiment fell from 35.2% to 29.0%.

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 since October 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 rose to a nine-month high of 5.6% from 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 rose to a four-week high of 11.2% from 11.1%, 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 5.4% is only 0.2ppts lower and STEG of 10.0% 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 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 was at a record high of 2.09 on an ex-Energy basis. On an ex-Energy basis, the forward P/E of 17.9 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, and forward earnings rose for six sectors. Consumer Discretionary and Financials were the only sectors to have both measures edge lower 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 1.31 compares to a record high of 1.56 in May 2016, and its P/E of 25.0 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 dropped 0.1ppt for Real Estate. Here's how they rank based on their current forward profit margin forecasts: Information Technology (21.0%), Real Estate (17.2), Financials (16.4), Telecom (11.3), Utilities (11.4), S&P 500 (11.1), Health Care (10.7), Materials (10.6), Industrials (9.2), Consumer Discretionary (7.5), Consumer Staples (6.8), and Energy (5.3).

US ECONOMIC INDICATORS

GDP (*link*): Real GDP growth for Q3 was stronger than first reported, expanding 3.3% (saar) (vs. the 3.0% advance estimate), the strongest since Q3-2014. It follows a 3.1% gain during Q2, marking the first time in three years that growth expanded at least 3.0% for two consecutive quarters. Real consumer spending grew a revised 2.3% (saar), little changed from the 2.4% initial estimate. Goods consumption expanded 4.1% (saar)—coming on the heels of a 5.4% gain during Q2—with spending on durable goods (8.1%, saar) slightly faster than Q2's 7.6% but nondurable goods (2.0) just half of Q2's gain. Services' spending slowed from 2.3% to 1.5% (saar). Real nonresidential investment expanded 4.8% (saar)—faster than the initial estimate of 3.9%, following a 6.7% increase the prior quarter. Robust spending on equipment (10.4%) and intellectual property products (5.8) more than offset a slump in structures (-6.8). Meanwhile, inventory investment improved for the second quarter, rising to $39.0 billion (saar)—above the advance estimate of $35.8 billion—from $5.5 billion during Q2 and $1.2 billion during Q1. Trade was a positive as real exports rose (2.2) and real imports (-1.1) fell. Partially offsetting these positive contributions were negative contributions from real residential fixed investment (-5.1) and state & local government (-0.1) spending, with the latter more than offset by a 1.3% (saar) rise in federal spending.

Contributions to GDP Growth (*link*): Real consumer spending once again was the number-one contributor to real GDP last quarter, while residential investment was a drag on growth again. Some details: (1) Real consumer spending accounted for 1.60ppts of real GDP growth during Q2 as goods consumption added 0.89ppt—durable (0.59ppt) and nondurable (0.30)—while services contributed 0.71ppt. (2) Inventory investment (0.80) was the number two contributor to Q3 growth—mostly nonfarm-related (0.72). (3) Nonresidential fixed investment (0.59ppt) also contributed positively to GDP growth as gains in spending on equipment (0.56) and intellectual property products (0.23) more than offset a decline in and structures (-0.20). (4) Trade (0.43) added to growth for the third consecutive quarter after detracting from growth at the end of last year; exports contributed 0.27ppt during Q3, while imports added 0.17ppt. (5) Real government spending (0.07) was basically neutral, as a positive contribution in federal spending (0.08) more than offset a slight negative contribution from state & local spending. (6) Residential investment (-0.20) was a negative contributor for the second quarter after adding to growth the previous two quarters.

Pending Home Sales (*link*): The Pending Home Sales Index—measuring sales contracts for existing-home purchases—rebounded strongly in October, though remained below year-ago levels. The index jumped 3.5% to a four-month high of 109.3 after falling the prior three months by 4.0%. Sales sank 0.6% y/y last month, the sixth negative reading in the past seven months, narrowing from September's -3.9%. While sales rose in every region but the West last month, sales remained below year-ago levels in three of the four regions: the West (-4.4% y/y), the Northeast (-1.9), and the Midwest (-0.9); sales in the South rebounded 7.4% in October, pushing them 2.0% above a year ago. NAR's chief economist, Lawrence Yun, said the supply and affordability headwinds seen most of this year have not abated this fall, noting: "Home shoppers had better luck finding a home to buy in October, but slim pickings and consistently fast price gains continue to frustrate and prevent too many would-be buyers from reaching the market."

GLOBAL ECONOMIC INDICATORS

Eurozone Economic Sentiment Indicators (*link*): The November Economic Sentiment Indexes (ESI) for the Eurozone (+0.5 points to 114.6) and the EU (+0.1 points to 114.3) climbed to their highest readings since October 2000 and June 2007, respectively. This month, ESIs for four of the five largest Eurozone economies improved, led by a 1.9-point gain in France to 112.0—its best level since November 2007. ESIs for the Netherlands (+0.8 to 111.8, highest since November 2007), Spain (+0.6 to 110.8, highest since December 2015), and Italy (+0.2 to 112.1, highest since June 2006) were also in the plus column, while Germany's (-0.1 to 114.4)—which had jumped 2.1 points in October to its best level since April 2011—posted a slight negative this month. At the sector level, increases in confidence were widespread, with construction (+1.2 to 1.6), consumer (+1.2 to 0.1), industry (+0.2 to 8.2), and services (+0.1 to 116.3) sentiment at cyclical highs, while retail trade (-1.3 to 4.2) sentiment held near recent highs.

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