MORNING BRIEFING
December 7, 2017

Tech Fender Bender

See the collection of the individual charts linked below.

(1) Odd number. (2) The day the music died. (3) Tech gets hit on tax bill, net neutrality, and attack by old guard. (4) Taxing intellectual property. (5) Tax reform could increase taxes for tech companies. (6) FCC set to vote against net neutrality. (7) Tech still delivering good earnings growth. (8) No sign of geopolitical risk in S. Korea's Kospi. (9) S. Korea, Singapore, and Taiwan all booming along with global demand for semiconductors.

Tech: Three Bad Things. "Three's the charm." That's an adage often applied to marriages and other pursuits. Fail at something? Keep trying. You'll probably succeed by the third time. On the other hand, there's the old wives' tale that "bad things come in threes," especially when it comes to celebrity deaths. While a Google search failed to turn up any credible source for the saying, the notion that famous people die in threes seems to have taken root when Buddy Holly, Ritchie Valens, and The Big Bopper perished in a plane crash together in 1959. At the end of 2016, Alan Thicke, George Michael, and Carrie Fisher all died unexpectedly. Here are a few more morbid threesomes: Michael Jackson, Ed McMahon, and Farrah Fawcett; David Bowie, Alan Rickman, and René Angélil; Prince, Chyna, and Doris Roberts.

The S&P 500 Tech sector hasn't died, but it has had a tough month after receiving three bad pieces of news. This week, investors seemed to rotate out of Tech upon realizing the Republicans' tax bill would benefit other S&P 500 sectors more than the Tech sector. Last month, President Trump's administration announced it would rescind net neutrality, which could mean higher costs for tech companies providing content and services over the web. And finally, old-line retailers and media companies appear to have grown more competitive in recent battles with the tech titans. Crowds flocked to Macy's on Black Friday, Disney is bidding for 21st Century Fox, and CVS is buying Aetna before Amazon invades its turf.

Since its recent peak, on November 28, the S&P 500 Information Technology sector has fallen 3.9% through Tuesday's close, making it the worst-performing sector in the S&P 500 over that period: Telecom Services (3.8%), Financials (3.5), Energy (2.3), Consumer Staples (2.3), Consumer Discretionary (1.4), Industrials (1.2), Materials (0.3), S&P 500 (0.1), Health Care (-0.4), Real Estate (-1.6), Utilities (-1.8), and Tech (-3.9).

With the notable exceptions of Financials and Real Estate, the performance derby ytd is the mirror opposite of the above results: Tech (33.8%), Financials (19.3), Consumer Discretionary (19.2), Health Care (19.0), Materials (18.9), S&P 500 (17.5), Industrials (15.0), Utilities (13.2), Consumer Staples (9.4), Real Estate (6.6), Energy (-7.9), and Telecom Services (-10.9) (*Fig. 1*).

The good news is that after three bad events, one's luck is bound to change (if you haven't been pronounced dead yet). And since the Tech sector still offers some of the market's fastest growth, with reasonable multiples, we remain optimistic about its future. Let's take a look at the crystal ball:

(1) *Reforming taxes.* In recent days, investors have been favoring sectors of the economy that stand to

benefit the most from tax reform, and Tech is not one of them. The tax reform bill would bring the federal tax rate down to 20% from the current 35%. Those benefitting the most would be the companies that pay the highest tax rate, and in general companies that generate most of their income domestically have the highest tax bills. Companies with the lowest rates tend to either have operations in countries with low tax rates or they've transferred their intellectual property to foreign countries with low tax rates.

Tech had both the lowest five-year median effective tax rate (24%) and the lowest percent of its sales from the US (41%), according to a 12/1 CNBC article citing 2016 data from Compustat and Goldman Sachs Global Investment Research. Here are the tax rates for other sectors: Health Care (26%), Materials (27), Financials (28), Consumer Staples (30), Consumer Discretionary (30), Utilities (31), Industrials (32), Telecom Services (33), and Energy (35).

The Tech sector would certainly be among the largest beneficiaries if cash stashed overseas can be repatriated at a low rate and presumably used for stock buybacks or dividends. Right now, both "House and Senate proposals would impose a one-time levy on (overseas profits)—whether assets are repatriated or not—at 14% on liquid assets under the House proposal and 10% under the Senate's," a 12/1 *WSJ* article reported.

However, the Tech sector wouldn't fare as well as other sectors if a global minimum tax on foreign income is established to discourage placing operations or intellectual property in countries with low tax rates. The bills would impose a global minimum tax of 10% on the income earned abroad even if it's not repatriated. In addition, the bill would make some payments between US companies and their foreign units subject to a 20% tax.

Finally, the Senate bill includes a 20% alternative minimum tax (AMT). If the federal tax rate were reduced to 20%, it would mean less use of the research credit by many tech and pharma companies, as using the credit would cause the AMT to kick in.

(2) *Real world implications.* Since we can't predict what the final tax law will look like, we decided to examine the 2016 tax bills of Merck, Apple, Home Depot, JPMorgan, and United Technologies. After doing so, it's clear why so much money is spent on lobbying about taxes—the dollars at stake are huge: Merck had the lowest effective income tax rate, 15.4%, followed by United Technologies (23.8), Apple (25.6), JPMorgan (28.4), and Home Depot (36.3).

The biggest reduction in taxes was typically due to income generated overseas. For example, if Merck's 2016 income were taxed at 35% with no deductions, it would have paid \$1.6 billion in taxes. But because of foreign earnings primarily in Ireland, Switzerland, Singapore, and Puerto Rico, its taxes were lowered by almost \$1.6 billion. The tax the company did pay, \$718 million, was related to purchase accounting adjustments, state taxes, restructuring, and US health care reform legislation, according to the company's annual report.

R&D research credits do reduce taxes, but for the companies we examined the impact was far less than the savings from generating income in foreign countries with lower tax rates. For example, if Apple paid the federal income tax rate of 35%, it would have paid \$21.5 billion of taxes, according to its 2016 annual report. However, because it had earnings from foreign subsidiaries that were indefinitely reinvested outside the US, its tax bill was reduced by \$5.6 billion. The R&D research credit only reduced its taxes by \$371 million. At the end of the day, the company paid \$15.7 billion in taxes.

It's not just tech and pharma names that have reduced their taxes by generating income abroad. United Technologies' tax rate was lowered by 8.1 percentage points because of the "lower tax rates on international earnings for which we intend to permanently reinvest outside the United States," according to its 2016 annual report.

Conversely, it came as little surprise that Home Depot, with 91.5% of its sales in the US, had a 36.3% tax rate, which amounted to a $4.5 billion tax bill in 2016. Business tax credits lowered JPMorgan's tax rate by 3.9 percentage points, and tax-exempt income lowered it by another 3.1 percentage points, helping to reduce its tax rate to 28.4% last year.

(3) *Neutral no longer*. With a new sheriff comes new rules. And in late November, the Federal Communications Commission Chairman Ajit Pai announced plans to reverse the Obama administration's rules governing Internet traffic. Under net neutrality, companies that sell Internet service aren't allowed to decide what content flows over the network or at what speed content is transmitted.

Net neutrality was considered important because "most Americans only have one or two options for high-speed internet service at home, which gives internet providers a lot of control," reported a 11/22 *WSJ* article. However, new FCC Chairman Pai believes net neutrality stifles innovation and investment. His proposal will be voted on by the FCC on December 14, and it's expected to pass.

In this new scenario, "internet providers will now be free to negotiate payment deals with websites. In one scenario, your internet provider might speed up Netflix while slowing down Hulu because Netflix has agreed to pay. Chairman Pai says companies will be free to create new business models that could lower costs for consumers or deliver more reliable connections for online services people want," the *Journal* noted.

While the new rules could face a legal challenge, or be reversed under future administrations, for now they're creating a lot of uncertainty for companies delivering content or services over the Internet. Stock investors don't like uncertainty, and these issues touch a wide array of industries. Amazon and Netflix are in the S&P 500 Internet & Direct Marketing industry, and Disney and Time Warner are in the S&P 500 Movies & Entertainment industry. In the S&P 500 Tech sector, Facebook and Google are in the Internet Software & Services industry, while Microsoft and Apple are in the Systems Software and Technology Hardware, Storage, & Peripherals industries.

(4) *The data*. Despite all the hand wringing, the Tech sector continues to offer some of the fastest growth at the lowest cost. The sector is expected to have revenue growth of 9.9% over the next 12 months, demonstrably faster than the 11 other S&P 500 sectors: Materials (7.9), Energy (7.8), Consumer Discretionary (5.9), Real Estate (5.9), S&P 500 (5.7), Health Care (5.3), Industrials (5.0), Consumer Staples (3.7), Financials (3.6), Utilities (3.5), and Telecom (2.3).

Tech is also forecasted to have some of the strongest earnings growth over the next year: 13.1%. Its earnings growth is eclipsed by the Energy (43.9%), Materials (19.5) and Financials (15.1) sectors. But Tech still bests the forward earnings growth of the S&P 500 (11.1%), Consumer Discretionary (8.7), Industrials (8.6), Consumer Staples (7.5), Health Care (6.8), Utilities (4.4), Telecom (-0.4), and Real Estate (-10.2) (*Fig. 2*).

Even though it offers above-average earnings growth, the Tech sector's forward P/E remains merely average at 18.8. The sectors with multiples higher than the Tech sector include: Real Estate (39.9), Energy (25.1), Consumer Discretionary (20.6), Consumer Staples (19.5), and Industrials (19.0). And those with lower multiples aren't much below the Tech sector's multiple: Utilities (18.6), Materials (18.4), S&P 500 (18.4), Health Care (16.7), Financials (14.8), and Telecom (12.7) (*Fig. 3*, *Fig. 4*, *Fig. 5*, and *Fig. 6*).

As a result, the Tech sector's market-capitalization share of the S&P 500, at 24.0%, is only slightly higher than its forward earnings contribution to the S&P 500, 23.5%. The rally this year in Tech shares is not a repeat of 1999 (*Fig. 7*).

South Korea: Make Semis, Not War. The US and South Korea joined forces Monday to conduct large-scale war games, a week after North Korea launched yet another missile, its most powerful yet. Twelve thousand troops and 230 aircraft, including top-of-the-line fifth-generation fighter jets —US F-22 Raptors as well as US F-35 Lightnings—took part in the aerial show of might dubbed "Vigilant Ace." It marked the largest ever concentration of fighter jets massed in South Korea. Mock strikes on mock missile and nuclear-testing sites were planned.

North Korea warned the combat exercises were leading the countries to the brink of war. You'd never know it by the action in South Korea's stock market.

Unfazed, South Korea's benchmark Kospi index has risen sharply since Monday as foreign investors stepped up to buy technology shares, a 12/4 article in Singapore's *Business Times* reported. The Kospi is up 23.9% ytd (dollars) through Tuesday at 2510.12, just off its record high of 2557.97 set last month. That compares with a 17.5% advance in the S&P 500 ytd and a 25.6% jump in the Nasdaq.

Neither the threat of nuclear war nor a Chinese boycott of South Korea's consumer goods in retaliation for deploying a US missile shield has been able to halt the surging South Korea stock market, one of the best performing of the MSCI global stock price indexes ytd, in local currency and US dollar terms. The South Korea MSCI share price index is up 44.5% ytd in dollars and 29.9% ytd in won through Tuesday. In contrast, the Emerging Market MSCI share price index is up 29.6% ytd in dollars and 24.3% ytd in local currency while the Emerging Market Asia MSCI share price index has risen 35.8% ytd in dollars and 29.9% in local currency. Only China has performed better among Asian emerging markets, up 45.4% ytd in dollars and 46.3% ytd in yuan.

Let's look more closely at the dynamics driving South Korea's market and economy:

(1) *Semi offensive.* With demand for memory chips booming amid the data-driven crush of the Internet of Things and AI, South Korea is reaping the benefits. Home to both Samsung, the world's biggest chipmaker in terms of sales, and No. 3 SK Hynix, South Korea is the world's second-biggest producer of chips next to the US. Global semiconductor sales continued their torrid strength in October, reaching a record $37.1 billion. The three-month moving average of global sales climbed by 21.9% y/y and 3.2% m/m (*Fig. 8*).

(2) *Quickening GDP growth.* South Korea's economy expanded 1.5% q/q in Q3, revised upward from preliminary estimates, according to an 11/30 article in the *Financial Times.* On a y/y basis, GDP expanded 3.8%, more than the forecast 3.6%. The quarterly increase was the fastest rate of growth in seven years, as private consumption rose on higher spending on services and durable goods. Construction investment expanded at a 1.5% clip (*Fig. 9*).

As a result of the strong showing, the Bank of Korea upped its forecast for GDP growth in 2017 to more than 3.0%.

(3) *Exports are chipper.* Exports, which account for 40% of GDP, jumped 6.1% q/q in Q3 on increased shipments of semiconductors, chemical products, and motor vehicles (*Fig. 10*). That was in sharp contrast to the 2.9% contraction in Q2 as petrochemical shipments declined. In November, exports rose 9.6% y/y, the 13th straight month of gains. Exports to China rose 20.5% y/y, suggesting a thaw in the frosty relations between the two countries that existed earlier this year.

(4) *Output soaring.* Firms reported the fastest expansion of new orders in four and a half years in November, on a pronounced uptick in domestic demand, according to the 12/1 Nikkei-Markit South Korea Manufacturing PMI survey. The PMI increased to 51.2 in November from 50.2 in October, the best pace since April 2013. To meet the order demand, firms boosted production at the fastest rate since February 2015. Optimism among manufacturers jumped to a 19-month high (*Fig. 11*).

(5) *Interest-rate hike.* In response to the buoyant economic activity, the Bank of Korea lifted its benchmark interest rate on 11/29 for the first time since 2011, by 0.25% to 1.50%. It was the first time a central bank in Asia raised interest rates since 2014, a 11/29 article in Bloomberg noted (*Fig. 12*).

(6) *Valuation.* Trading at a forward P/E of 8.9, the MSCI South Korea share price index looks inexpensive relative to its historical trading levels and compared with estimated earnings growth of 11.7% for 2018. Earnings estimates have been continuing to rise.

Singapore & Taiwan: Semis Boom. The boom in semiconductors is also lifting export-oriented Singapore and Taiwan. The MSCI stock price index of the former is up 30.3% ytd in dollars and 21.7% ytd in local currency, and Taiwan's index is up 22.6% ytd in dollars and 14.1% ytd in local currency. While we are on our Asian tour, consider the following developments in Singapore and Taiwan:

(1) *Singapore Sling.* Singapore's GDP grew at the fastest rate in nearly four years during Q3, notching 5.2% growth y/y, according to an 11/23 release from the Ministry of Trade and Industry, thanks to a synchronized global recovery and strong global electronics demand. Manufacturing gained 18.4% y/y, and finance and insurance expanded 5.9% y/y. Construction activity contracted by 7.6%. The Ministry upgraded its GDP outlook for 2017 to 3.0%-3.5% from 2.0%-3.0%. The Nikkei Singapore PMI rose to 55.4 in November, the highest reading in more than three years, from 54.2 in October.

Taiwan's economy advanced 3.1% y/y in Q3, beating estimates, on healthy demand for semiconductors. The Nikkei Taiwan Manufacturing PMI rose at the sharpest rate since April 2011, climbing to 56.3 in November from 53.6 in October, driven by the strongest increase in export sales in three years.

(2) *Hedge clause.* The pace of Singapore's growth in 2018 is expected to moderate but remain "firm," based on an expected easing in Eurozone and China demand. Also, the Ministry cautioned that "at this relatively advanced stage of the US's economic recovery, an upside surprise in inflation cannot be ruled out." It continued: "Should this happen, monetary policy in the US could normalise faster than expected, thereby causing global financial conditions to tighten more than anticipated." Still, Singapore's manufacturing sector is expected to continue to expand and provide support on the back of healthy demand in the global semiconductor and semiconductor equipment markets. The Ministry sees 2018 GDP growth likely to come in the middle of its forecast range of 1.5%-3.5%.

(3) *Price inflation.* With vendors unable to meet demand, delivery times have lengthened, disrupting the supply chain and driving up prices, according to a 12/1 report by IHS Markit. In Taiwan, increases in raw material prices also drove prices higher, leading to the steepest jump in inflation since early 2011.

(4) *Valuation.* Trading at a forward P/E of 14.3, the MSCI Singapore share price index looks pricey compared with its estimated earnings growth of 9.0% for 2018 (*Fig. 13*). Trading at forward P/E of 13.9, the MSCI Taiwan share price index looks fully valued compared with its estimated 2018 earnings growth of 10.7%.

CALENDARS

US. **Thurs:** Jobless Claims 240k, Consumer Credit $17.3b, Challenger Job-Cut Report, Weekly Consumer Comfort Index, EIA Natural Gas Report, Dudley. **Fri:** Nonfarm & Private Payroll Employment 190k/184k, Unemployment Rate 4.1%, Average Hourly Earnings 0.3%m/m/2.6%y/y, Average Workweek 34.4hrs, Consumer Sentiment Index 98.8, Wholesale Inventories -0.1%, Baker-Hughes Rig Count. (*Wall Street Journal* estimates)

Global. **Thurs:** Eurozone GDP 0.6%q/q/2.5%y/y, Germany Industrial Production 1.0%m/m/4.3%y/y, Japan GDP 1.5% (saar), Japan Leading & Coincident Indexes 106.1/116.2, Draghi. **Fri:** Germany Trade Balance (euros) 21.9b, UK Headline & Manufacturing Industrial Production 3.5%/3.8% y/y, UK NIESR GDP Estimate 0.4%, BOE/TNS Inflation Next 12 months, China CPI & PPI 1.8%/5.9% y/y, China Trade Balance $34.7b, China Foreign Direct Investment. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): Our Bull/Bear Ratio (BBR) rose for the second week this week from 3.99 to 4.25, the seventh time in the past nine weeks the reading was 4.00 or higher. It reached 4.47 four weeks ago, which was the highest reading since March 1987! Bullish sentiment has been at 60.0% or above for the past nine weeks, climbing from 61.5% to 64.2% the past two weeks, 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% 12 weeks ago. The correction count fell in 10 of the past 12 weeks, from 32.7% to 20.7%—nearly matching its low for the year of 20.4% during the final week of February. Bearish sentiment was unchanged at 15.1% this week after two weeks at 15.4%; it began November at 14.4%, which was the fewest bulls since May 2015. The AAII Ratio fell to 53.2% last week after rising the prior week from 45.5% to 55.0%. Bullish sentiment rose for the second week from 29.4% to 36.0%, while bearish sentiment rose from 29.0% to 31.6% this week.

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 10-month high of 5.7% from 5.6%. 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 edged down to 11.1% from a four-week high of 11.2%, and 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 0.3ppts lower and STEG of 10.0% is 1.1ppts 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 2.04, and was at a record high of 2.11 on an ex-Energy basis. On an ex-Energy basis, the forward P/E of 18.1 remains the highest since February 2004.

S&P 500 Sectors Earnings, Revenues & Valuation (*link*): Consensus forward revenue forecasts rose last week for 10/11 sectors, and forward earnings rose for five sectors. Materials was the only sector to have both measures edge lower w/w, and these three sectors had forward earnings drop more than 0.1% w/w: Industrials, Materials, and Real Estate. 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 25.1 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 Materials and Tech, and dropped 0.1ppt for Energy, Health Care, and Industrials. Here's how they rank based on their current forward profit margin forecasts: Information Technology (21.1%), Real Estate (17.2), Financials (16.4), Telecom (11.3), Utilities (11.4), S&P 500 (11.1), Health Care (10.6), Materials (10.5), Industrials (9.1), Consumer Discretionary (7.5), Consumer Staples (6.8), and Energy (5.2).

US ECONOMIC INDICATORS

ADP Employment (*link*): "The job market is red hot," according to ADP, "with broad-based job gains across industries and company sizes. The only soft spots are in industries being disrupted by technology, brick-and-mortar retailing being the best example. There is a mounting threat that the job market will overheat next year." In November, private industries added 190,000 to payrolls after an unrevised 235,000 jump in October, which followed September's hurricane-related slowdown of 96,000—the weakest since last fall. Service-providing industries (155,000) accounted for just over 80% of November's gain, though goods-producing industries (36,000) registered another strong performance, as manufacturers added a record 40,000 jobs last month; construction companies (-4,000) reduced payrolls for the first time in seven months after a six-month jump of 160,000. Within service-providing, once again the biggest increases came from professional & business services (47,000), health care & social assistance (31,000), and leisure & hospitality (25,000), with education (23,000) joining the list in November. Medium-sized companies moved from the bottom to the top slot in November, adding 99,000 to payrolls—74,000 service-providing and 24,000 goods-producing. Small companies (50,000) held onto the number-two spot, all service-providing (55,000) jobs. Large companies (41,000) fell from the top of the leader board to the bottom, posting its smallest gain in seven months—with a mix of 25,000 service-providing and 16,000 goods-producing jobs.

GLOBAL ECONOMIC INDICATORS

Germany Manufacturing Orders (*link*): October orders bucked expectations and rose to yet another new record high. Billings advanced for the third straight month, climbing 0.5% (vs forecasts for a 0.2% decline), following gains of 1.2% (vs 1.0% preliminary) in September and 4.1% in August. Both domestic and foreign orders rose for the third month, growing 3.7% and 7.1%, respectively, over the period—with the latter climbing to a new record high. October's 0.5% increase in foreign orders was fueled by a 1.6% advance in billings from outside the Eurozone, driven by a 2.6% advance in capital goods orders—which have soared 15.8% the past four months to a new record high. Orders from within the Eurozone slipped 1.2%, led by declines in intermediate (-2.7) and consumer (-1.5) goods orders; capital goods (-0.3) billings were little changed around recent highs. October's 0.4% gain in domestic orders reflected advances in consumer (2.3) and intermediate (1.2) goods billings; capital goods orders ticked down 0.4%.

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