



MORNING BRIEFING

January 4, 2018

2018: More Happy Returns?

See the [collection](#) of the individual charts linked below.

(1) Earnings expected to keep on trucking. (2) Higher oil prices and a weaker dollar are tailwinds for earnings. (3) Lots of positive earnings revisions leading up to corporate tax cut. (4) Reinsurance should bounce back, barring more disasters. (5) No disasters for other insurers last year, or this year. (6) Falling inventories and turmoil in Iran could give Energy sector an earnings boost, offset some by falling P/Es. (7) Outlook for Tech earnings winners still bright with reasonable P/Es. (8) Drone spotting.

Strategy: Earnings Driving Stocks Higher. As the new year gets underway, Wall Street's analysts are calling for S&P 500 earnings to climb 12.3% in 2018, a slight acceleration from 10.9% earnings growth expected for full-year 2017. The energy industry is benefiting from lofty crude oil prices, while other companies are profiting from the continued slide in the dollar and lower tax rates; the retailers and General Electric can look forward to easy comparisons to weak 2017 earnings to boot. Crude oil is up 20% y/y, and the trade-weighted dollar is down 8% y/y ([Fig. 1](#) and [Fig. 2](#)).

Here's what analysts currently are expecting for the S&P 500 sectors' earnings growth rates in 2018: Energy (41.0%), Materials (18.4), Financials (17.6), Tech (15.3), S&P 500 (12.3), Industrials (9.6), Consumer Discretionary (9.2), Consumer Staples (8.1), Health Care (6.7), Utilities (4.6), Telecom Services (1.2), and Real Estate (-10.2) ([Fig. 3](#)).

Earnings estimates often get trimmed as a new year kicks off, but this year they are more likely to be raised thanks to the passage of the tax bill and mounting evidence that the global economy continues to accelerate. Over the past four weeks, forward earnings estimates have been revised upward by 1.6% for the S&P 500. Positive revisions have been even more dramatic in the Energy sector (6.5%), Financials (2.5), Tech (1.9), and Materials (1.7). The only sector that has seen its estimates trimmed is Real Estate (-1.2) ([Table 1](#)).

As is the norm, the average sector earnings estimate masks a wide array of earnings growth forecasts for the S&P 500's industries. The S&P 500 Reinsurance industry is anticipated to have the best earnings growth this year of the industries we track in the S&P 500: a 1,124.6% rebound from the 93.0% drop it incurred in 2017. The industry's bottom line in 2017 was decimated by losses from hurricanes, fires, and earthquakes.

At the other end of the spectrum, Industrial REITs are forecasted to see a 69.3% drop in earnings, as many properties are at peak levels and loftier interest rates could mean higher financing costs. The earnings drop also occurs because profits from property sales have boosted 2017's results, but analysts don't predict what sales will occur in 2018 so they're not factored into earnings. Let's dig into the range of earnings outcomes predicted for 2018:

(1) *Betting on better weather.* Last year, natural disasters made minced meat of the insurance industry's profits. The only positive outcomes are the easy comparisons the industry will enjoy this year to 2017's depressed results. The insurance industry's surge will strengthen the S&P 500 Financials sector—already on strong footing thanks to the earnings strength of banks, brokers, and asset

managers that's expected to continue in the new year.

In addition to a major bounce in the S&P 500's Reinsurance industry's earnings, analysts are forecasting a rebound in the Property & Casualty Insurance industry, with earnings expected to rise 52.2% this year after falling 19.3% last year ([Fig. 4](#)). The same pattern is expected in the S&P 500 Multi-Sector Holdings industry (BRKB and LUK): 30.9% jump in earnings forecasted for 2018 after earnings fell 9.2% last year ([Fig. 5](#)). Earnings growth in the Insurance Brokers industry (AJG, AON, MMC, and WLTW) is expected to accelerate to 16.0% this year from 5.8% in 2017 ([Fig. 6](#)). And a second year of good earnings is expected for the Multi-Line Insurance industry (AIG, AIZ, HIG, and L), with 58.0% earnings growth forecasted for this year after 83.6% growth last year ([Fig. 7](#)).

The anticipated rebounds in the insurance-related industries should more than offset the slight deceleration projected in some other areas of Financials. Earnings in the Asset Management & Custody Banks is expected to rise 10.8% in 2018 after a 17.6% gain in 2017; likewise, growth should slow for Investment Banking & Brokerage (13.3% this year, 20.7% last year) and Regional Banks (11.3, 19.4), while earnings improve at Consumer Finance (14.6, 3.5) and Diversified Banks (13.9, 9.6).

(2) *Gushing profit growth.* Energy is by far the sector with the strongest earnings growth prospects. Unfortunately, it currently accounts for only 6.1% of the S&P 500's market capitalization, so its impact will be limited relative to sectors with larger market caps like Tech (23.8%), Financials (14.8), Health Care (13.9), Consumer Discretionary (12.2), and Industrials (10.2). That said, every bit of good news helps.

The Energy sector has been boosted by the 48.5% jump in the price of Brent crude oil since June 21, 2017. At the current price, Brent is at the high end of the range in which it has traded since late 2014. The market has been helped by the late 2016 deal struck by OPEC members and other major producers to limit production. Then Hurricane Harvey came along last summer and reduced inventories as refiners were shut down during the storm. More recently, the turmoil in Iran has given oil prices a boost.

High US crude inventory levels have been dropping since this summer and are now lower than where they started both 2017 and 2016 ([Fig. 8](#)). However, US production has risen in November and December after dipping in October, and now production is well above levels of the past two years ([Fig. 9](#)).

Analysts are optimistic about most of the industries in the Energy sector, as it continues to rebound from losses in 2016. The Oil & Gas Exploration & Production industry is forecasted to have 269.2% earnings growth this year, followed by the Oil & Gas Equipment & Services industry (62.1%), Oil & Gas Refining & Marketing (32.8), Integrated Oil & Gas (23.1), and Oil & Gas Storage & Transportation (13.8) ([Fig. 10](#), [Fig. 11](#), [Fig. 12](#), [Fig. 13](#), and [Fig. 14](#)). The only industry still reporting losses—albeit sharply smaller ones than it incurred in 2017—is the Oil & Gas Drilling industry.

(3) *Tough tech.* Given its market cap, one of the most important calls of the year is whether to underweight or overweight the S&P 500 Tech sector. While the overall sector is expected to have respectable earnings growth this year, it's really some of the insanely fast-growing Tech industries that continue to attract dollars and attention. After growing earnings by 42.1% in 2016 and another 65.7% last year, the Semiconductor Equipment industry is bound for a third year of rapid growth in 2018, with 29.5% projected.

Likewise, the Application Software industry is expected to grow earnings by 24.8% this year, after increases of 21.2% in 2016 and a forecasted 22.8% in 2017 ([Fig. 15](#)). Other Tech industries that are

expected to grow earnings by more than 20% are Internet Software & Services (21.2%) and Technology Hardware, Storage & Peripherals (22.1%).

Valuations: P/Es Upticking. Thanks to strong earnings growth, the S&P 500's forward P/E inched only modestly higher over the past year despite the market's strong rally. The S&P 500's forward P/E stands at 18.5 as of Tuesday's close, up only a few notches from 17.2 a year ago.

Here's where all of the S&P 500 sectors' P/Es stand now and their levels a year ago: Real Estate (39.8 now, 37.8 a year ago), Energy (25.1, 32.4), Consumer Discretionary (21.2, 18.3), Consumer Staples (19.9, 19.3), Industrials (19.5, 17.9), Tech (18.7, 16.6), Materials (18.5, 17.1), S&P 500 (18.5, 17.2), Utilities (17.3, 17.0), Health Care (16.7, 14.4), Financials (14.8, 14.1), and Telecom Services (13.4, 14.2).

(1) *Thank Energy.* Expansion of the S&P 500 forward P/E remains subdued in part because the S&P 500 Energy sector's forward P/E is actually lower now than it was a year ago, at 25.1 vs 32.4. That's because the Energy sector's earnings, which are rebounding from losses in 2016, are improving faster than Energy stocks are rising.

Excluding the Energy sector, the S&P 500's forward P/E would be 18.2, up from 16.5 a year ago, according to Joe's calculations. In other words, were it not for Energy the S&P 500's forward P/E would have expanded by 9.7% y/y instead of the 7.5% it did ([Fig. 16](#)).

The S&P 500 Oil & Gas Exploration & Production industry forward P/E has fallen to 45.6 from 107.2 a year ago. Likewise, the Oil & Gas Equipment & Services industry P/E is 29.3, down from 56.4. The P/E declines in other industries are less significant: Oil & Gas Refining & Marketing (14.4 currently, 14.5 a year ago), Integrated Oil & Gas (22.0, 23.8), and Oil & Gas Storage & Transportation (27.0, 29.8).

(2) *Tech rising temperately.* Despite its strong run, the S&P 500 Tech sector's 18.7 P/E isn't as high as might be expected, and it certainly doesn't approach the 40-plus P/Es at which the sector traded during the Tech bubble of the late 1990s ([Fig. 17](#)). The most expensive industry in the Tech sector currently is Application Software, with a forward P/E of 35.9, up from 32.4 a year ago. While high relative to other industries, the P/E isn't unjustified if the industry produces the 24.8% earnings growth forecasted for this year.

Along the same lines, Internet Software & Services has a forward P/E of 25.6, but forecasted earnings growth of 21.2%, and Technology Hardware, Storage & Peripherals, home to Apple, has a forward P/E of 13.9 despite the 22.1% growth forecasted for this year.

(3) *Blame Amazon.* The S&P 500 industry with the highest P/E, Internet & Direct Marketing Retail, resides in the Consumer Discretionary sector even though it counts Amazon and Netflix as constituents. Its forward P/E, at 72.8, has increased significantly over the past year from 52.1. But this industry also has monster growth forecasted for this year: 37.1%.

So while stock prices and forward P/Es have risen over the course of the past year, earnings did too and are expected to continue doing so in 2018. The punchbowl is still on the table.

Drones: Flying High. NBC has a great, relatively new reality show *Better Late than Never*. This is no *Housewives* copycat. It features Henry Winkler (famous for his role as The Fonz, *Happy Days*), William Shatner (Captain Kirk, *Star Trek*), George Foreman (boxer and grill pitchman), Terry Bradshaw (quarterback, sports commentator), and Jeff Dye (young comedian) having a great time tromping around Europe this year and Asia in 2016. It's family-friendly entertainment with a bunch of laughs and

a little history set in beautiful places around the world.

When the gang was in a park in South Korea, they had a picnic delivered to them by drone. This made us wonder how far the rest of the world has advanced with the technology. Here's what we found:

(1) *Delivering food in Iceland.* AHA, Iceland's largest eCommerce company, is working with Flytrex's drone system to deliver goods between two parts of the city Reykjavik, which is divided by a river. CEO Maron Kristofersson [explains](#) that AHA can save 20 minutes of labor per delivery by sending orders "as the drone flies" instead of paying drivers to circumnavigate the city's many bays.

(2) *Burrito deliveries in Australia.* Google affiliate Project Wing is testing a drone delivery service with an Australian Mexican taqueria chain and a drugstore company. The tests are in a rural community near Canberra, where buying most things requires a 40-minute roundtrip, a 10/18 CNN [article](#) reported. Goods will be delivered right to homeowners' backyards.

Success won't come easily. "The issues range from programming the devices to maneuver safely around obstacles like parked cars or outdoor furniture to following customers' wishes to set down perishable food items close to their kitchens," the article noted.

(3) *Pizza deliveries in New Zealand.* Domino's is experimenting with pizza delivery via drone in New Zealand. "A Domino's customer who requests a drone delivery will receive a notification when their delivery is approaching. After going outside and hitting a button on their smartphone, the drone will lower the food via a tether. Once the package is released, the drone pulls the tether back up and flies back to the Domino's store," according to an 8/26/16 CNN [article](#).

At the time the article was written, there was a major barrier: New Zealand's drone rules don't allow a drone to fly farther than the drone's operator can see.

(4) *Parcel deliveries in China.* [JD.com](#) had regulatory approval to fly parcels via drones in four provinces over 20 fixed routes at the start of last year, according to a 1/27/17 Recode [article](#), with plans to expand both the number of provinces and routes during 2017.

"We try to deliver with drones from cities to the countryside," explained JD's CEO Richard Liu in the article. "In every village, we have a delivery man who lives in the village, and he will take the parcels [delivered by drone] to different houses." Each drone may carry 8-15 packages ordered in the village.

[JD.com](#) isn't alone. Alibaba has used drones to carry boxes to islands in China's Fujian province since last fall, according to an 11/9 [article](#) on [Xinhuanet.com](#).

(5) *Amazon's in the running too.* Amazon has tested drone deliveries in the UK, but it needs regulatory relief to make deliveries in the US possible. The US moved in that direction in October when President Trump "signed an executive order designed to speed the approval of drone flights over crowds and for longer distances. The administration says it wants to open new commercial uses for the aircraft and create jobs," noted a 10/25 Bloomberg [article](#).

Amazon has filed for a patent for "beehive like towers that would serve as multilevel fulfillment centers for its delivery drones to take off and land. The facilities would be built vertically to blend in with high rises in urban areas. Amazon envisions each city would have one," a 6/23 CNN [article](#) explained. "The towers could support traditional truck deliveries and include a self-service area where customers can pick up items, the patent states. It also details how employees would attach the packages on drones."

Soon, we may never need to leave our homes again.

CALENDARS

US. Thurs: ADP Employment 185k, Jobless Claims 240k, Challenger Job-Cut Report, NM-PMI 52.4, Weekly Consumer Comfort Index, EIA Natural Gas Report, EIA Petroleum Status Report. **Fri:** Total Nonfarm, Private, and Manufacturing Payroll Employment 190k/184k/17k, Unemployment & Participation Rates 4.1%/62.7%, Average Hourly Earnings 0.3%*m/m*/2.5%*y/y*, Average Workweek 34.5hrs, Merchandise Trade Balance -\$50.5b, Factory Orders 1.0%, ISM NM-PMI 57.6. (*Wall Street Journal* estimates)

Global. Thurs: Eurozone, Germany, France, and Italy Composite PMIs 58.0/58.7/60.0/56.0, Eurozone, Germany, France, and Italy NM-PMIs 56.5/55.8/59.4/54.7, UK NM-PMI 54.0, China Caixin NM-PMI 51.8. **Fri:** Eurozone CPI Headline & Core Flash Estimate 1.4%/1.0% *y/y*, Germany Retail Sales 1.0%*m/m*/2.3%*y/y*, Canada Employment Change & Unemployment Rate 0.0k/6.0%, Japan Composite & NM-PMIs. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators ([link](#)): Our Bull/Bear Ratio (BBR) slipped to 4.07 this week from 4.25 during the week of December 19 (Investor Intelligence didn't publish data for the final week of December). It was the tenth time in the past 12 reporting weeks that the reading was 4.00 or higher; it was at 4.47 during the last week of November—which was the highest reading since March 1987! Bullish sentiment retreated to 61.9% this week from 64.1% during the week of December 19—which was just shy of its record high of 64.9% posted in early 1987; it has been at 60.0% or above since the week of October 10. Bearish sentiment was little changed at 15.2% this week, fluctuating between 15.1% and 15.4% since mid-November; it began November at 14.4%, which was the fewest bulls since May 2015. The correction count climbed to 22.9% from 20.8% two weeks ago, which was near its low for the year of 20.4% during the final week of February. The AAI Ratio rose for the third week last week from 51.9 to 71.8 over the three-month period. Bullish sentiment rose for the sixth consecutive week from 29.4% to 52.7%, while bearish sentiment fell for the third week from 34.2% to 20.6%.

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 rose to a record high of 11.2%. The profit margin had been steady at 11.1% since October, which was the highest since September 2015 and up from a 24-month low of 10.4% in March 2016. Forward revenue growth for the S&P 500 was steady at 5.6%, which is down from a 10-month high of 5.7% at the end of November. Those readings compare to 5.8% in January 2017, which was the highest since May 2012, and a cyclical low of 2.7% in February 2016. Forward earnings growth rose to a six-year high of 11.8% from 11.5%. That compares to a cyclical low of 4.8% in February 2016. Forward growth for the S&P 500 is 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 forward growth was 5.4% for revenues and 10.8% for earnings. 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 of 18.5 is the highest since May 2002 and up from a 15-month low of 14.9 in January 2016. The S&P 500 price-to-sales ratio was steady at a record high of 2.06, and was at a record high of 2.13 on an ex-Energy basis. The ex-Energy forward P/E of 18.2 is the highest since January 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 all but Utilities. 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 1.37 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 2018 for all but Real Estate and Telecom. In the latest week, the forecasted forward profit margin rose 0.2ppt for Financials and 0.1ppt for Telecom. Here's how the sectors rank based on their current forward profit margin forecasts: Information Technology (21.3%), Real Estate (16.9), Financials (16.6), Utilities (11.4), Telecom (11.4), S&P 500 (11.2), Materials (10.7), Health Care (10.6), Industrials (9.2), Consumer Discretionary (7.5), Consumer Staples (6.8), and Energy (5.5).

US ECONOMIC INDICATORS

Auto Sales ([link](#)): Motor vehicle sales in December remained at a high level, driven by light trucks. Total sales advanced from 17.5mu to 17.9mu (saar) in December, within 0.7mu of September's 12-year high of 18.6mu, which was boosted in part by consumers in hurricane-hit parts of the country replacing flood-damaged vehicles. Light-truck sales, which led September's rebound, climbed for the first time in three months to 9.6mu (saar) last month, just shy of September's 9.7mu peak—which was the strongest showing since the summer of 2005. Domestic car sales continued to unwind their hurricane-related increase, falling steadily from last year's high of 5.0mu in September to 4.4mu (saar) in December, matching its low for the year. Sales of imports (3.9mu, saar) were fractionally below September's peak, which was the fastest pace since August 2009.

Construction Spending ([link](#)): November construction spending climbed for the fourth month, on widespread strength, reaching a new record high. Total investment advanced 0.8% in November and 3.4% over the four-month period (after a two-month slide of 1.7%), boosted by a 9.3% surge in public construction spending since July. Private construction investment rose for the third month, by 1.0% m/m and 2.0% over the period. Within private construction spending, nonresidential investment advanced 0.9%—only its third gain this year—recording a 3.3% ytd decline. Residential investment, on the other hand, has recorded only two losses this year, up 1.1% m/m and 7.2% ytd. Within residential investment, single-family construction remains strong, advancing 13 of the last 14 months by a total of 15.5%, while multi-family construction is down 6.3% in the seven months through November after a 5.5% jump the first four months of the year. Meanwhile, home-improvement spending rose for the fourth straight month, by a total of 4.0%, to a new record high.

GLOBAL ECONOMIC INDICATORS

Global Manufacturing PMIs ([link](#)): Global manufacturing activity in December accelerated at its fastest rate in nearly seven years, with new orders and output expanding at their best rates since February 2011—boosting both jobs growth and business optimism. The JP Morgan M-PMI rose for the sixth month from 52.6 in June to 54.5 last month; the developed nations (56.3) continued to record much stronger growth than emerging markets (52.2), though rates for both are accelerating. The Eurozone M-PMI (60.6) recorded its best reading in the history of the series, going back to mid-1997. Austria (64.3, record high) moved to the top of the leader board, with Germany (63.3, record high) and the Netherlands (63.3) not far behind with readings above 60.0. Also posting impressive numbers were Ireland (59.1, record high), France (58.8, 207-month high), Italy (57.4), and Spain (55.8); Greece (53.1, 114-month high) remained above 50.0 for the seventh month after contracting steadily for many years.

Among other leading developed nations, rates of increase accelerated in the US (55.1, 33-month high) and Japan (54.2, 46-month)—with the latter's based on its flash estimate; UK (56.3) manufacturing growth slowed, but remained robust near November's 51-month high of 58.2. M-PMIs for the main emerging nations showed growth accelerating in India (54.7, 5-year high), Russia (52.0, 5-month high), and China (51.5, 4-month high), while Brazil's (52.4) remained in expansionary territory near November's 81-month high of 53.5.

US Manufacturing PMIs ([link](#)): Manufacturing activity in December accelerated at a robust pace according to both the ISM and Markit surveys. The ISM M-PMI (to 59.7 from 58.2) rose for the first time in three months, climbing back near September's 60.8—which was its best performance since May 2004! The new orders (to 69.4 from 64.0) and production (65.8 from 63.9) indexes accelerated at their fastest rates since 2004, with both above 60.0 for the seventh month. The employment (57.0 from 59.7) measure eased for the third month, though is not far from October's recent peak of 60.3—which was the highest reading since June 2011. Meanwhile, the supplier deliveries (57.9 from 56.5) gauge retraced some of November's setback, while the inventories (48.5 from 47.0) measure contracted for the third month, though at a slower pace. Markit's M-PMI (55.1 from 53.9) showed manufacturing activity expanded at its fastest rate since March 2015, supported by the fastest increases in output and new orders in nearly a year, and the best job creation since September 2014.

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