



MORNING BRIEFING

January 30, 2018

Profits: Us vs Them

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

(1) Profits growth during recoveries and expansions. (2) TCJA bumps earnings growth above 7% long-term trend line. (3) Analysts are predicting much higher earnings from tax cut than we are. (4) Stocks are more fairly valued if the analysts are right about earnings. (5) Analysts' estimated tax-cut impact on corporate profits implies big hit to corporate taxes collected by US Treasury. (6) The Bond Vigilantes Model has been too bearish on bonds since the start of the current expansion. (7) Central banks' QE programs and weak economic growth have kept yields down. (8) Fed rate hikes and normalization of ECB and BOJ monetary policies, along with faster US growth, could push US yields higher.

Earnings: Permanent One-Shot Deal. During economic recoveries, corporate profits growth soars at double-digit rates as both revenues and profit margins rebound. During the expansions that follow recoveries, corporate profits tend to grow around 6%-7% per year ([Fig. 1](#) and [Fig. 2](#)). Trump's tax cuts have made hash of this simple model. Consider the following:

(1) *Us, before and after TCJA.* Without those tax cuts, Joe and I estimate that S&P 500 after-tax earnings per share would have increased at the 7% annual rate to \$141 this year and \$151 next year. Our back-of-the-envelope calculation is that the Tax Cut and Jobs Act (TCJA) enacted late last year will boost earnings by \$6 this year to \$147 per share, which would be a 12% y/y increase. Next year, the 7% trend resumes, with earnings rising to \$158 per share. (See [YRI S&P 500 Earnings Forecast](#).) Our \$6 estimate is based on a pre-TCJA effective tax rate of 25% for the S&P 500.

(2) *Them, before and after TCJA.* Just before the TCJA's December 22 enactment, industry analysts were projecting earnings of \$146.26 per share for 2018 and \$161.07 for 2019. Now just six weeks since then, they've raised their 2018 consensus estimate by \$7.16 to \$153.42 and their 2019 estimate by \$7.87 to \$168.94 ([Fig. 3](#)). Their estimates imply growth rates of 16.4% this year and 10.1% next year, compared to 11.2% and 10.1% before the TCJA.

Industry analysts have a well documented tendency to be too optimistic about the outlook for earnings further out and to lower their estimates approaching earnings seasons. The tax cut at the end of last year allowed them to add a significant amount to their already optimistic forecasts for 2018 and 2019. The tax cut should be fully reflected in their estimates once the current earnings season is over. Then we would expect to see their estimates coming back down closer to planet Earth.

(3) *Q4 earnings season isn't over.* Joe reports: "We should get a broader consensus earnings boost not with the next [TJCA Earnings Tracker](#) report (which will be on 1/31 with data dated 1/25), but with the subsequent report due out 2/7 with data through 2/1, and thereafter for a few more weeks. It will pick up as earnings season kicks into high gear next week. Retailers will be the last to report, and after their estimates are adjusted for the TCJA, we can pick out final winners and laggards." So by the end of the current earnings season, we should get a good handle on the one-shot impact of the tax cut on S&P 500 earnings, as well as which industries gained the most from the TCJA.

(4) *P/E implications.* If we use yesterday's closing price for the S&P 500 and divide it by the analysts'

2018 earnings estimate, we get a 2018 P/E of 18.6; using our estimate, we get 19.4. The comparable 2019 valuation multiples are 16.9 (theirs) vs 18.1 (ours).

(5) *Implications of the analysts' numbers.* Let's assume that the analysts' current \$7.16-per-share estimated boost to date for the one-shot impact of the TCJA on S&P 500 earnings is correct. We can use that increase to estimate the total tax savings to S&P 500 corporations and revenue loss to the US Treasury. Their number implies a 5% boost to earnings per share. The latest data available for aggregate S&P 500 net operating income is for Q3-2017 ([Fig. 4](#)). It was \$1.1 trillion at an annual rate. A 5% increase would amount to a \$54 billion recurring annual windfall from the permanent tax cut.

That would also be the amount by which the US Treasury's revenues from corporate income taxes would be hit. Over the past 12 months through December, these revenues totaled \$283 billion ([Fig. 5](#)). So the implied loss of \$54 billion in corporate revenues from S&P 500 companies would bring this total down to \$229 billion assuming all else equal over the next 12 months. Corporations weren't paying much in US federal income taxes and will be paying at least 5% less after the TCJA ([Fig. 6](#)). Compare this drop to the 40% statutory corporate-tax-rate drop from 35% to 21%. This analysis confirms our view that corporations have been paying a much lower effective tax rate than 35%.

Bonds: A Bearish GDP Model. There are only a few models that are useful for forecasting the bond yield. Specifically, they are useful for suggesting where the bond yield should be, but not where it is actually going next. The Bond Vigilantes Model (BVM) simply compares the yearly percent change in nominal GDP growth to the 10-year US Treasury bond yield ([Fig. 7](#)). According to data released last week, nominal GDP growth was 4.4% during Q4-2017. The bond yield is currently around 2.70%, well below nominal GDP growth.

The BVM shows that since 1953, the yield has fluctuated around the growth rate of nominal GDP. However, both the bond yield and nominal GDP growth tend to be volatile. While they usually are in the same ballpark, they rarely coincide. When their trajectories diverge, the model forces me to explain why this is happening.

Since the start of the current economic expansion, the bond yield has been below nominal GDP growth. Obviously, the Fed's QE programs—entailing purchasing trillions of dollars in US Treasury and mortgage-backed securities—explains the divergence ([Fig. 8](#)). However, the Fed terminated QE during October 2014, yet the bond yield remains relatively low compared to nominal GDP growth.

The explanation for the divergence may be that the ECB and BOJ continue to pursue ultra-easy monetary policies. Both have slightly negative official rates. Both are still expanding their assets with QE programs ([Fig. 9](#)). As a result, government bond yields remain extremely low in Germany (0.55%) and Japan (0.07%) ([Fig. 10](#)).

So the bond yield is in the middle of a tug of war between relatively solid growth in nominal GDP in the US on one side and near-zero bond yields in Germany and Japan on the other. Odds are that the ECB soon will start normalizing its monetary policy. The BOJ may already have slowed the pace of its QE program. If so, then the US bond yield likely is headed still higher, probably to 3.0% then possibly higher.

The US bond yield is likely to be pushed higher by three to four hikes in the federal funds rate by the Fed this year, moving this rate above 2.00% ([Fig. 11](#)). Trump's tax cuts could boost real economic growth and perhaps boost inflation. Debbie and I are more inclined to expect the former than the latter, as inflation remains remarkably subdued. The PCED rose 1.7% y/y through December, while the core PCED was up 1.5% ([Fig. 12](#)).

CALENDARS

US. Tues: Consumer Confidence 123.4, S&P CoreLogic Case-Shiller HPI 0.6%*m/m*/6.4%*y/y*, FOMC Begins. **Wed:** ADP Employment 195k, Employment Cost Index 0.6%, Pending Home Sales Index 0.4%, Chicago PMI 64.0, MBA Mortgage Applications, EIA Petroleum Status Report, FOMC Meeting Announcement 1.375%. (*Wall Street Journal* estimates)

Global. Tues: Eurozone GDP 0.6%*q/q*/2.7%*y/y*, Eurozone Economic Confidence 116.2, Germany CPI -0.6%*m/m*/1.7%*y/y*, France GDP 0.6%*q/q*/2.3%*y/y*, Japan Industrial Production 1.5%*m/m*/3.2%*y/y*, BOJ Summary of Opinions, Carney. **Wed:** Eurozone Headline & Core CPI 1.3%/1.0% *y/y*, Eurozone Unemployment Rate 8.7%, Germany Unemployment Change & Unemployment Claims Rate -17k/5.4%, Germany Retail Sales -0.4%*m/m*/2.8%*y/y*, UK GfK Consumer Confidence -13, Canada GDP 0.4%*m/m*/3.4%*y/y*, Australia CPI 2.0% *y/y*, Japan Consumer Confidence 44.9, Japan Housing Starts 1.1% *y/y*, China M-PMI & NM-PMI 51.5/55.0. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): With the Q4 earnings season entering its heaviest phase and results becoming mixed due to one-time TCJA adjustments, we're turning our attention to the revision activity for the Q1-2018 earnings forecasts. The S&P 500's Q1-2018 EPS forecast rose *w/w* to \$35.83 from \$35.49. That's up 4.1% since the end of Q4 and 4.8% since the passage of the TCJA. The \$35.83 estimate represents a forecasted pro forma earnings gain for Q1-2018 of 16.7%, up from 16.0% a week earlier, and compares to Q4-2017's blended 13.2%, Q3-2017's 8.5%, 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 Q4, Q1-2018 estimates are higher for 10 sectors and lower for one. Energy's Q1 forecast has jumped 16.5%, followed by the forecasts for Financials (up 10.6%), Telecom (7.1), and Consumer Discretionary (4.8). Real Estate's Q1-2018 forecast has fallen 0.9%, the sole decline among sectors, followed by small gains for Tech (0.8), Utilities (1.5), Consumer Staples (2.4), Health Care (2.5), Materials (3.3), and Industrials (3.3). The S&P 500's Q1-2018 forecasted earnings gain of 16.7% *y/y* would be its sixth straight gain after four declines, and its strongest since Q3-2011. All 11 sectors are expected to record positive *y/y* earnings growth in Q1-2018, and four are expected to beat the S&P 500's forecasted *y/y* earnings gain of 16.7%. That's because analysts expect Energy to report another large profit jump in Q1 relative to very low earnings a year ago. That's better than Q4-2017, when nine sectors are expected to rise *y/y*. All 11 sectors last rose *y/y* during Q2-2017, when it did so for the first time since Q3-2011. The latest forecasted Q1-2018 earnings growth rates vs their blended Q4-2017 growth rates: Energy (69.7% in Q1-2018 vs 140.3% in Q4-2017), Materials (26.1, 27.5), Financials (22.5, 14.7), Tech (20.5, 17.9), S&P 500 (16.7, 3.2), Industrials (12.7, 5.7), Consumer Staples (11.3, 9.5), Consumer Discretionary (10.6, 5.4), Health Care (7.8, 5.6), Utilities (7.4, 8.1), Telecom (6.5, -3.0), and Real Estate (4.9, -2.1). On an ex-Energy basis, S&P 500 earnings are expected to rise 14.8% *y/y* in Q1, up from a blended 10.7% in Q4 and 6.1% in Q3 (which was the slowest growth since ex-Energy earnings rose just 2.2% in Q2-2016).

S&P 500 Q4 Earnings Season Monitor ([link](#)): With nearly 27% of S&P 500 companies finished reporting earnings and revenues for Q4-2017, their revenue and earnings surprise metrics are better compared to the same point during the Q3 earnings season. Of the 133 companies in the S&P 500 that have reported, 80% exceeded industry analysts' earnings estimates by an average of 4.7%; they have averaged a *y/y* earnings gain of 15.2%. At the same point during the Q3-2017 reporting period, a lower percentage of companies (74%) in the S&P 500 had beaten consensus earnings estimates by a lower 2.7%, and earnings were up a lower 10.1% *y/y*. On the revenue side, 82% beat sales estimates so far, with results coming in 1.2% above forecast and 8.7% higher than a year earlier. At this point in the Q3

season, a lower 72% had exceeded revenue forecasts by a similar 1.2%, and sales had risen by a lower 5.5% y/y. Q4 earnings results are higher y/y for 82% of companies vs a lower 78% at the same point in Q3, but revenues are higher y/y for 93% during Q4 vs a lower 84% a quarter ago. These figures will change markedly as more Q4-2017 results are reported in the coming weeks. Q4's earnings surprise is typically smaller relative to Q3 because Financials typically clear their books at the end of the year, so we're pleased to see these metrics improving q/q. The early results on revenues are very encouraging, particularly with the percentage of companies growing y/y. Despite the potential negative impact of write-offs related to the TCJA, Q4-2017 should mark the sixth straight quarter of positive y/y earnings growth and the seventh quarter of positive revenue growth.

US ECONOMIC INDICATORS

Personal Income & Consumption ([link](#)): Consumers spent at a healthy clip last quarter as income gains accelerated. Real consumer spending rose 0.3% during the final month of 2017—its fourth consecutive monthly gain and its ninth for the year—led by durable goods (0.8%) and services (0.3) spending; nondurable goods consumption was flat in December after a 1.0% surge in November. For the quarter, real consumer spending accelerated 3.8% (saar)—the strongest rate in six quarters—led by an 8.2% jump in goods consumption; services spending rose 1.8%, a slight improvement from Q3's 1.1% advance. Within goods consumption, spending on consumer durable goods (14.2%, saar) was the best since Q3-2009, while nondurable goods outlays (5.2) was the highest since Q4-2010. Real wages & salaries climbed 0.3% in December and 3.1% y/y—the first reading above 3.0% since July 2016. Our Earned Income Proxy, which tracks consumer spending and wages & salaries closely, continues to set new highs, indicating stronger growth in both up ahead.

Regional M-PMIs ([link](#)): Five Fed districts have now reported on manufacturing activity for this month—New York, Philadelphia, Richmond, Kansas City, and Dallas—and they show growth in the sector remains strong. We average the composite, orders, and employment measures as data become available. The composite index slipped this month from 22.0 to 20.7—not far from October's reading of 23.7, which was the best reading since July 2004; it has averaged 22.0 the past five months. Of the five regions, the Dallas Fed's measure climbed to 33.7—its highest reading in more than 12 years; as for the remaining four regions, Kansas City's was the only one to show a slight acceleration in activity, with its composite index climbing from 13 to 16; Philadelphia (to 22.2 from 27.9), New York (17.7 from 19.6), and Richmond (14 from 20) all showed growth eased, though remained solid. The new orders gauge fell for the second month from 23.9 in November to a six-month low of 15.5 this month. Kansas City (14 from 11) showed a slight pickup in activity, while the Philly (10.1 from 28.2), New York (11.9 from 19.0), and Dallas (25.5 from 30.1) regions showed orders growth slowed from recent highs, though Dallas' remains in record territory. Meanwhile, Richmond's reading was unchanged at 16—though down from November's recent peak of 35. The employment measure fell from 19.8 to 12.8 this month as manufacturers in the Philadelphia (16.8 from 19.7), Dallas (15.2 from 20.4), and Richmond (10 from 20) regions continued to add to payrolls at a steady, though slower pace, while jobs growth in the New York (3.9 from 22.9) region slowed dramatically this month. Kansas City was the outlier, with its employment index accelerating from 16 to 18—back near its recent high of 19.

Contact us by [email](#) or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967

Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor & Webmaster, 570-775-6823

Copyright (c) Yardeni Research, Inc. Please read complete [copyright and hedge clause](#).