MORNING BRIEFING
February 1, 2018

How To Spend Tax Windfalls

See the collection of the individual charts linked below.

(1) Industrial sector was mighty strong even before tax cut. (2) Next boosters for sector could be infrastructure and defense spending. (3) Looking even better ex-GE. (4) Notes from three conference calls: Honeywell, Lockheed Martin, and Illinois Tool Works. (5) Repatriated earnings will be used for share buybacks, dividends, M&A, capital spending, and to increase matches for 401(k)s. (6) Simpler global tax structures will reduce accounting and legal costs. (7) The best offense is more defense spending. (8) Paying pension plans forward. (9) More R&D. (10) Hint of inflation. (11) Quacks disrupting healthcare.

Industrials: Building on Strength. The earnings coming out of the S&P 500 Industrials sector during the current earnings season indicate that all's well with the US and world economies despite the recent selloff in US stocks. During the year ahead, the sector should continue to enjoy solid global economic growth, in addition to the benefits of lower taxes and the repatriation of billions of dollars stashed overseas. The sector also stands to benefit if President Donald Trump can push through his proposal to spend $1.5 trillion on infrastructure and boost defense spending.

The sector's Q4-2017 operating earnings is expected to rise 6.2% y/y, which is two percentage points higher than analysts expected at the start of the year. The results look even better—14.6%—when the losses from General Electric are taken out of the mix. The upbeat outlook continues for Industrials in both Q1 and the full year 2018. The sector is expected to grow operating earnings by 12.9% in Q1 and 15.9% in 2018, according to analysts polled by Thomson Reuters. When GE's expected results are excluded from the estimates, the Industrials sector's estimated earnings growth pops up to 17.1% in Q1 and 18.0% in 2018.

Here's how Industrials' 2018 earnings growth estimate compares to those of the 10 other sectors in the S&P 500: Energy (58.6%), Financials (28.1), Materials (20.7), S&P 500 (17.0–17.2 without GE), Industrials (15.9–18.0 without GE), Consumer Discretionary (15.3), Tech (14.0), Consumer Staples (10.7), Telecom (10.4), Health Care (10.1), Real Estate (6.1), and Utilities (4.8).

Roughly half of the companies in the S&P 500 Industrials sector have reported Q4 earnings. About 78% of those earnings results were above estimates, and only 17% were below. Here are Jackie's highlights from the quarterly conference calls of Honeywell, Lockheed Martin, and Illinois Tool Works, which occurred over the past week. Their CEOs had much to say about taxes and the business environment:

(1) *Honeywell (HON)*. Executives spent much of the Q4 conference call discussing the implications of tax reform in 2018 and beyond. Some of the impacts are easily quantifiable: Honeywell's effective tax rate of 25%-26% will fall to 22%-23%. As a result, the company boosted its 2018 earnings forecast by 20 cents to $7.75-$8.00 a share, which represents a 9%-13% y/y increase.

Honeywell also announced plans to repatriate within the next two years about $7 billion of the $10 billion it holds overseas. Investors should expect additional cash to be repatriated as it's earned abroad.

CFO Thomas Szlosek explained what the repatriation will mean to Honeywell: "This new global mobility of our cash allows us to continue investing in our businesses in the US, to pay a competitive dividend, to more aggressively seek out M&A, particularly in the US, and to repurchase our own shares. Our preference is for attractive bolt-on acquisitions in our core markets. But to the extent M&A opportunities do not materialize, we will gradually accelerate share repurchases as we did in 2017."

The company also announced plans to use its tax savings to increase its 401(k) employer match for its US employees. "This change represents a sustained long-term commitment to provide enhanced financial security in retirement, which we believe is extremely valuable and important to employees. Honeywell remains committed to being an employer of choice," explained CEO Darius Adamczyk on the conference call. In Q4, the company also decided to increase its dividend by 12%, and it repurchased 10.3 million shares.

It's notable that Honeywell does not plan to use the tax savings to increase capital spending. Capex has run north of $1.1 billion in 2014-2016. It will be down "in the $900 million range or less" this year, and it will continue to decline. "[I]t's important to note we're not constraining capex; it's just that we have gone through a fairly substantial investment cycle, and we just see that waning a bit. But if we see great projects, we're going to continue to invest," explained Adamczyk.

That said, he expects his customers to spend more on capex, which should benefit Honeywell. We "certainly see a much greater level of bullishness on the part of our customers, which should translate to continued investment. And you're right, their capex is our revenue, and we do expect some level of investments to accelerate, said Adamczyk.

Scott Davis, an analyst at Melius Research, raised one of the most interesting subjects in the conference call when he questioned whether Honeywell could simplify its corporate structure or supply chain now that it doesn't need various corporate entities around the world to shelter income from US taxes. Turns out, Honeywell has started looking at simplifying its legal entities.

CEO Adamczyk explained: "[I]t will require us to restructure ourselves, and we do believe that new structure long term will be simplified, will cost us less, will make it a lot easier to do business. Can I quantify that for you right now? I can't, because we literally just started our work a couple of weeks ago. But I do anticipate there will be a source of value for Honeywell and our shareholders." Should tax attorneys start looking for a new area of expertise?

As for Q4, Honeywell reported organic sales growth of 6% and operating EPS growth of 6%, excluding a $3.8 billion charge related to the Tax Cuts and Jobs Act (TCJA). The results beat analysts' estimates, and each of the company's divisions—Aerospace, Home and Building Technologies, Performance Materials and Technologies and Safety and Productivity Solutions—reported organic sales growth.

Honeywell is a member of the S&P 500 Industrial Conglomerates, which has declined by 7.8% y/y through Tuesday's close because of the downward pull of GE (*Fig. 1*). The industry is expected to have forward revenue growth of 3.4% and forward earnings growth of 3.3%, again due to GE (*Fig. 2*). Despite the drop in GE, the industry continues to trade at a lofty forward P/E of 20.3. It has traded near that level for the past two years, and only during the heady late 1990s has it traded much higher (*Fig. 3*).

(2) *Lockheed Martin (LMT)*. Thank you, Uncle Sam. Defense spending has risen steadily in recent years, and it's expected to continue to do so. President Trump has requested $626 billion in baseline defense spending in addition to $65 billion in overseas contingency spending for fiscal 2018—up from

$591 billion in fiscal 2017—but he still needs spending authorization from Congress. Longtime defense analyst Rick Whittington expects the President to up the ante again by requesting $716 billion in defense spending in fiscal 2019.

Lockheed Martin—which makes F-35s, Sikorsky helicopters, and missile and missile defense systems—has benefitted from the surge of defense spending. Q4 sales rose 10.1%, and operating earnings jumped by 32.3% before a $1.9 billion charge related to the TCJA. The high end of the company's 2018 forecast range has sales rising by as much as 3% and earnings jumping 16.5%.

Lockheed also talked taxes in its 1/29 conference call. Under the Trump tax cuts, its tax rate should drop to 17%-18%, down from roughly 27% last year. The new tax regime prompted the company to make a $5 billion contribution to its pension plans, essentially prepaying its 2018, 2019, and 2020 pension plan obligations to maximize the related tax deduction.

The 1/9 *WSJ* explains: "U.S. companies have until mid-September to benefit from the higher 35% corporate tax rate when deducting their defined-benefit pension plan contributions from their tax bill. A $1 million pension plan contribution made during this time can still count toward the 2017 tax bill and will result in a $350,000 tax deduction. The value of the deduction falls to $210,000 for contributions of the same size made under the new tax rules for 2018."

Lockheed also plans on boosting R&D and capital spending this year by a combined $200 million. Lockheed spent almost $1.2 billion on capex last year, a record level. The company will also increase the Lockheed Martin Ventures investment fund, which makes strategic investments in early-stage companies that are developing technologies in areas important to Lockheed.

There are additional initiatives under consideration. CEO Marillyn Hewson said on the conference call: "Some of these initiatives include increasing our employee training and educational offerings to drive critical skill development [and] increasing our charitable contributions in science, technology, engineering, and math, or STEM, programs—the life blood of our future talent pool—including the creation of a STEM scholarship fund to encourage participation in these important fields of study."

Before the company spends its tax windfall, management should read a 1/29 *WSJ* article questioning whether federal officials would require defense contractors to pass the tax savings back to Uncle Sam in the form of lower prices. Uncle Sam giveth, Uncle Sam taketh away?

Lockheed is part of the S&P 500 Aerospace & Defense stock index, which has risen 49.8% over the past year (*Fig. 4*). The industry's revenue is expected to grow 3.7% over the next 12 months, and earnings are forecasted to climb 12.8% over the same period (*Fig. 5*). Of possible concern: The industry's forward P/E of 22.2 is higher than it's been since 1995 (*Fig. 6*).

(3) *Illinois Tool Works (ITW)*. ITW enjoyed a strong Q4, with organic revenue increasing 4%, margins improving, and operating EPS jumping 17%. The growth was broad based, as six of the company's seven segments and all of its major geographies enjoyed organic revenue growth: 4% in North America, 3% in Europe, and 5% in Asia-Pacific, which includes a 7% pop in China.

Domestically, ITW had started to see business investment accelerate in Q4, prior to the passage of the tax legislation, said CFO Michael Larsen in the company's 1/24 conference call. "[T]his new tax legislation has great potential to add some further momentum and stimulation to the economy overall and in particular to business investment." The company forecasts 3%-4% organic revenue growth this year.

The tax changes will lower ITW's tax rate to 25%-26% this year, down from 28.3% last year. Lower taxes will boost earnings by $0.35 per share, or 5% this year. As a result, the company is targeting 2018 EPS of $7.45-$7.65, a 15% y'y jump if the middle of the range is achieved.

ITW took a $658 million charge in Q4 related to the tax changes, which equates to $1.92 per share. The company plans to repatriate about $2 billion to the US by the end of this year, but declined to lay out what it will do with that cash. In December, however, ITW did accelerate its previously announced plan to increase its dividend payout ratio to 50% of free cash flow in August instead of by 2020. The current dividend ratio is 43%.

ITW regularly spends 2% of sales on capex, and executives don't seem likely to increase that because of the tax changes. "We [were] already [fully] invested in businesses and in our strategy before the passage of this tax legislation. So there's nothing that we would do or could do now that we didn't do … any changes on the tax side …don't have any impact there," noted CEO Scott Santi.

ITW's pension funds are fully funded after the company made an extra payment of about $150 million last year.

One interesting line of questioning addressed inflation. Larsen said there "certainly is some inflation that is being addressed in our business units. But I think we have it well covered in our current guidance. … [our strategy] is to offset any material cost inflation dollar for dollar with price [increases], and we have been able to do that successfully at the enterprise level."

ITW is a member of the S&P 500 Industrial Machinery Index, which has risen 28.8% y/y through Tuesday's close (*Fig. 7*). Revenue over the next 12 months is expected to grow 5.7%, while forward earnings is forecast to climb 12.4% (*Fig. 8*). Growth in this industry also doesn't come cheap, as the industry's forward P/E is 20.8. That's the high end of the P/E range in which the stock has traded since 1995 (*Fig. 9*).

Healthcare: Quakes at the Gate. Healthcare investors have been on edge since this fall after numerous reports indicated that Amazon might jump into the prescription drug business. At the time, we noted that the drug industry—with its opaque pricing, multiple layers of distribution, and sales through physical stores—was ripe for disruption.

Turns out, the truth is scarier than the rumor—for healthcare industries anyway. Amazon, JPMorgan, and Berkshire Hathaway are forming a nonprofit company that aims to reduce healthcare costs for their US employees. Companies have long provided insurance directly to employees. This joint venture, however, is notable because it will focus on technological solutions that can provide simplified and transparent healthcare for employees at a lower cost, the 1/30 *WSJ* reported.

The new company is the latest salvo in efforts by private industry to lower healthcare costs. Earlier this month, four large hospital chains said they would create a nonprofit generic drug company to reduce shortages of commonly used medicines in hospitals and prevent sudden price increases.

In 2015, Caterpillar, Verizon, American Express, and Macy's banded together to use their market power to hold down the cost of healthcare benefits. The group, the Health Transformation Alliance (HTA), now has roughly 45 members and 7 million employees, and it spends $26 billion annually on healthcare.

The goal of the organization is to provide the right care to the right patient, at the right time to get the best results, explained HTA's CEO Robert Andrews in an 11/21/17 podcast. The group aims to change the incentive structure under which providers are compensated, and it uses IBM's Watson to identify effective healthcare providers. If a doctor is skilled at managing diabetes and saves money by doing so, they'll pay that doctor more, Andrews explained.

HTA focused on cutting the cost of pharmaceuticals first. The cost of middlemen represents roughly 30% of the cost of a drug, Andrews says. So the HTA had a competitive process among pharmacy benefit managers, and starting this year members are expected to save 15% on their drug spending.

The group is also focused on diabetes, hip and knee replacements, and back pain. The treatment of those four ailments represents roughly 40% of healthcare spending, and the common thread between them is obesity and poor nutrition. The annual cost of healthcare for a healthy person is $4,000. The cost of care for a diabetic is $18,000 a year. So they're not looking to reduce the care being provided to patients. Instead, they're looking to keep employees healthier because doing so will cost less in the long run, Andrews explained.

If the S&P 500 Health Care sector's stock performance is any indication, the potential for savings must be large. On Tuesday, the day the Amazon news was reported, Health Care was the worst-performing sector, down 2.1%, nearly twice the S&P 500's 1.1% drop. Among the industries taking the hardest hits were Drug Retail, down 4.6%; Life & Health Insurance, down 4.5%; and Managed Health Care, down 4.4% (*Fig. 10*).

CALENDARS

US. Thurs: Total & Domestic Motor Vehicle Sales 17.3mu/13.1mu, Construction Spending 0.5%, Jobless Claims 235k, Productivity & Unit Labor Costs 1.1%/0.9%, ISM & Markit M-PMI 58.7/55.5, Weekly Consumer Comfort Index, Challenger Job-Cut Report, EIA Natural Gas Report. **Fri:** Total, Private, and Manufacturing Payroll Employment 175k/172k/18k, Unemployment & Participation Rates 4.1%/62.7%, Average Hourly Earnings 0.3%m/m/2.6%y/y, Average Workweek 34.5hrs, Consumer Sentiment Index 95.0, Factory Orders 1.5%, Baker-Hughes Rig Count, Williams**.** (*Wall Street Journal* estimates)

Global. Thurs: Eurozone, Germany, France, and Italy M-PMIs 59.6/61.2/58.1/57.3, UK M-PMI 56.5, Japan M-PMI. **Fri:** None. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): Our Bull/Bear Ratio (BBB) rose from 5.05 to 5.24 this week, back near the 5.25 reading two weeks ago—which was the highest since early April 1986. Bullish sentiment climbed from 64.7% to 66.0%, just shy of the 66.7% reading two weeks ago—which was the most bulls since early April 1986. That's the 16th consecutive reading of 60.0% or higher. The bears barely changed again this week, ticking down to 12.6%, which is the fewest bears since early April 1986. The correction count fell from 22.5% to 21.4% this week. The AAII Ratio fell to 65.4% last week after rising from 66.0% to 71.7% the previous week. Bullish sentiment fell from 54.1% to 45.5% last week, while bearish sentiment rose from 21.4% to 24.0%.

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 rose yet another 0.1ppt for a fifth straight week to a record high of 11.6%. Prior to the passage of the TCJA, 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 remained steady at a 12-month high of 5.7%. That reading compares 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 jumped

0.8ppt w/w to 15.6% from 14.8%, and is the highest since October 2010. That's up a whopping 4.5ppts from 11.1% prior to the passage of the TCJA, and 10.8ppts from the cyclical low of 4.8% in February 2016. Energy and Telecom had the biggest w/w improvement in forward earnings growth; Energy surged 5.1ppts to 51.3%, and Telecom rose 4.4ppts to 8.5%. 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 5.3% for revenues and 14.2% for earnings. The S&P 500 ex-Energy forward profit margin rose to a record high of 12.2%, which is up from 11.7% before the TCJA. The forward P/E edged up to a 16-year high of 18.6 from 18.5, which compares to the 15-month low of 14.9 in January 2016. The S&P 500 price-to-sales ratio rose to a record high of 2.16, and was at a record high of 2.23 on an ex-Energy basis. The ex-Energy forward P/E rose to a 14-year high of 18.3 from 18.2.

S&P 500 Sectors Earnings, Revenues & Valuation (*link*): Consensus forward earnings forecasts rose last week for all 11 sectors. However, forward revenues rose w/w for 8/11 sectors (all but Consumer Staples, Industrials, and 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 appear to be back on uptrends after stalling during 2016-2017, but its valuations remain elevated; its P/S ratio of 1.42 compares to a record high of 1.56 in May 2016, and its P/E of 23.8 is down from a record high of 57.5 then. Higher y/y margins are expected in 2018 for all but Real Estate, but the sector's earnings includes gains from property sales and typically improve as the year progresses. The forward profit margin rose 0.4ppt w/w for Telecom, 0.3ppt for Energy, 0.2ppt for Industrials, and 0.1ppt for six of the remaining eight sectors. Here's how the sectors rank based on their current forward profit margin forecasts: Information Technology (21.5%), Financials (18.3), Real Estate (17.0), Telecom (12.2), S&P 500 (11.6), Utilities (11.5), Materials (11.0), Health Care (10.8), Industrials (9.7), Consumer Discretionary (7.9), Consumer Staples (7.0), and Energy (6.0).

S&P 500 Q4 Earnings Season Monitor (*link*): With 37% 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 185 companies in the S&P 500 that have reported, 80% exceeded industry analysts' earnings estimates by an average of 4.9%; they have averaged a y/y earnings gain of 14.9%. 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 1.4% above forecast and 8.3% higher than a year earlier. At this point in the Q3 season, a lower 72% had exceeded revenue forecasts by a lower 1.2%, and sales had risen by a lower 5.5% y/y. Q4 earnings results are higher y/y for 80% of companies vs a lower 78% at the same point in Q3, and revenues are higher y/y for 92% during Q4 vs a higher 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. 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

ADP Employment (*link*): "The job market juggernaut marches on. Given the strong January job gain, 2018 is on track to be the eighth consecutive year in which the economy creates over 2 million jobs. If it falls short, it is likely because businesses can't find workers to fill all the open job positions," according to ADP. In January, private industries added 234,000 to payrolls—the fourth straight month of 200,000-

plus readings—following a slight downward revision to December (to 242,000 from 250,000) and a bigger upward revision to November (206,000 from 185,000) for a net gain of 13,000. Service-providing industries (212,000) accounted for 90% of January's gain, though goods-producing industries (22,000) registered another relatively strong performance, led by gains in both manufacturing (12,000) and construction (9,000) jobs, which have increased 201,000 and 253,000, respectively, the past 12 months. Within service-providing industries, the increase was broad based, with trade, transportation & utilities (51,000), professional & business services (46,000), leisure & hospitality (46,000), and health care & social assistance (41,000) all posting gains north of 40,000. By company size, medium-sized companies remained at the top of the leader board, adding 91,000 jobs—79,000 service-providing and 12,000 goods-producing. Large companies (85,000) were a close second, with a mix of 77,000 service-providing jobs and 8,000 goods-producing ones. Small companies moved to the bottom slot, adding 58,000 to payrolls—nearly all service-providing (56,000).

Employment Cost Index (*link*): Labor costs in the private sector slowed a bit last quarter, but accelerated at the fastest pace in several years on a year-over-year basis. Private industry compensation climbed 0.5% during Q4, pushing the yearly rate up to 2.6% y/y—that's above the 2.2% gain at the end of 2016 and the best rate since Q1-2015. Wages & salaries rose 2.8% y/y last quarter—matching Q1-2015's rate, which was the highest since mid-2008. Several service-related industries posted yearly gains above 3.0% last quarter: leisure & hospitality (3.8% y/y), wholesale trade (3.4), retail trade (3.3), and transportation & warehousing (3.1). Benefits' costs rose 0.4% during Q4 and 2.3% y/y—slowing slightly from Q3's 2.4%, which was also the best rate since Q1-2015.

Pending Home Sales (*link*): The Pending Home Sales Index—measuring sales contracts for existing-home purchases—rose slightly for the third straight month in December. The index edged up 0.5% during the month, to its highest reading since last March; sales were 0.5% above a year ago—the second straight reading above zero, after several months below. Sales were above year-ago levels in the South (4.0% y/y) and Midwest (0.3) and below year-ago levels in the West (-3.1) and Northeast (-2.7). NAR's chief economist Lawrence Yun noted, "Another month of modest increases in contract activity is evidence that the housing market has a small trace of momentum at the start of 2018"; however, he cautioned that "buyers throughout the country continue to be hamstrung by record low supply levels that are pushing up prices—especially at the lower end of the market."

GLOBAL ECONOMIC INDICATORS

Eurozone CPI Flash Estimate (*link*): January's CPI rate is expected to slow to a six-month low of 1.3% y/y, according to the flash estimate, after easing from 1.5% to 1.4% in December. So January's rate should remain below the ECB's goal of just under 2.0%. Looking at the main components, rates for energy (to 2.1% from 2.9% y/y) and food, alcohol, and tobacco (1.9 from 2.1) once again are expected to slow. Meanwhile, the rate for non-energy industrial goods (0.6 from 0.5) is expected to post its highest rate in nearly a year; services inflation is expected to be unchanged at 1.2% y/y. The core rate—which excludes energy, food, alcohol, and tobacco—is expected to edge up to 1.0% y/y from 0.9% the prior three months.

Japan Industrial Production (*link*): Japan's industrial production beat expectations in December, climbing to its highest level since October 2008. Headline production jumped at an eight-month high of 2.7% last month—nearly triple the expected advance of 1.5%—following gains of 0.5% in each of the prior two months. Upon the release of December's data, METI maintained its assessment of industrial production, saying that it is picking up. Leading December's gain was output of fabricated metals (9.2%), transport equipment (6.3), and business-oriented machinery (4.8). Meanwhile, manufacturers polled by the METI said they expect production to fall 4.3% in January, but then rebound 5.7% in February.

Japan Consumer Confidence (*link*): Consumer confidence in January held steady at December's 44.7 reading—which was just below November's 50-month high of 44.9. The gauge measuring employment (to 49.7 from 49.0) jumped to its best reading since September 2013. Meanwhile, the remaining three components—willingness to buy durable goods (43.7 from 43.8), income growth (42.9 from 40.3), and overall livelihood (42.6 from 42.9)—all eased during the month, though remained near recent highs.

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