



MORNING BRIEFING

February 6, 2018

Fundamentally Strong

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

(1) While valuation may be an issue, earnings are no problem for stock prices. (2) Measures of business revenues growth are strong. (3) S&P 500/400/600 forward revenues rising in record territory. (4) January M-PMIs confirm that global economy is strong. (5) TCJA has boosted analysts' 2018 EPS consensus for S&P 500/400/600 by 6.2%, 5.1%, and 6.0% so far. (6) Each quarter of 2018 likely to show double-digit growth rates for S&P 500 earnings. (7) TCJA likely to reduce federal corporate income taxes from \$283 billion last year to \$211 billion this year.

Strategy I: Revenues Growth Rising. The stock market may or may not have an overvaluation problem. That depends on whether historically low inflation and interest rates justify today's historically high P/Es, as Joe and I believe. Of course, if both inflation and interest rates are headed significantly higher, then the recent swoon in stock prices may continue to recalibrate valuation levels lower. In any event, the stock market certainly doesn't have an earnings problem. The cut in the corporate income tax has been a big booster for 2018 earnings expectations, as we update in the next section.

While all the focus has been on the tax cut and its positive impact on earnings since the start of this year, revenues growth coincidentally has picked up smartly thanks to the strength in the global economy. It's hard to believe that the record high of 2872.87 on the S&P 500 on January 26 marked the end of the latest bull market given the quickening pace of revenues growth. Consider the following:

(1) *US business sales.* There's a very high correlation between the y/y growth rates of S&P 500 revenues (a quarterly series) and business sales (a monthly series) ([Fig. 1](#)). In Q3-2017, S&P 500 revenues was up 5.0% y/y; in November 2017, business sales (the sum of factory shipments and distributors sales) was up 8.0%. The latter represents that series' fastest growth since February 2012, thanks in part to the rebound in energy prices. Excluding the revenues of the Energy sector, S&P 500 revenues was up 4.0%, while business sales excluding petroleum rose 6.3% ([Fig. 2](#)).

(2) *2018 & 2019 revenues.* While industry analysts can estimate the impact of the tax cut on earnings, they can't do the same for revenues. Yet since the end of last year through the end of January, they boosted their expectations for S&P 500 revenues growth during 2018 from 5.6% to 6.1% ([Fig. 3](#)). Simultaneously, they've raised their 2019 revenues-per-share estimate by 1.0% since the end of last year.

Are we all supply-side economists now? Is it possible that industry analysts have turned more bullish on revenues because they expect that President Donald Trump's tax reform measures will boost the economy? More likely is that they are getting guidance from corporate managements indicating that their sales are strong because the global economy is strong.

(3) *Forward revenues.* Joe and I like to track S&P 500 forward revenues, which is now the time-weighted average of 2018 and 2019 revenues estimates of industry analysts for the S&P 500 ([Fig. 4](#)). That's because this weekly series tracks the trend in the actual S&P 500 quarterly revenues closely.

The weekly series has been rising rapidly into record-high territory since September 2016. Over the past year, the same can be said for the forward revenues of the S&P 400 and S&P 600 ([Fig. 5](#)).

(4) *Global economy*. Again, unless industry analysts are all drinking Trump's supply-side Kool-Aid, their optimism about revenues must mostly reflect the upbeat global economic picture. The day before the market's tightening tantrum last Friday, strong January manufacturing PMIs were released from around the world. The global M-PMI remained high at 54.4—with the sub-index of the advanced economies edging up to a robust reading of 56.3, while the sub-index for the emerging economies edged down to a still-respectable reading of 51.9 ([Fig. 6](#)). Among the advanced economies, M-PMIs for the US (59.1) and the Eurozone (59.6) remained elevated, while Japan's rose to a recent high of 54.8, and the UK's edged down to 55.3 ([Fig. 7](#)).

Interestingly, the US M-PMI is a relatively good leading indicator of S&P 500 revenues growth ([Fig. 8](#)). The former is currently predicting that the latter will remain strong.

Strategy II: TCJA Boosting Earnings Estimates. All the above suggests that the 2018 outlook for earnings was already very good late last year given the strength in the global economy—even before the tax cut. Just prior to the passage of the Tax Cut and Jobs Act (TCJA) on December 22, 2017, industry analysts were estimating that S&P 500/400/600 earnings would grow 11.2%, 14.3%, and 20.6% this year ([Fig. 9](#)). Since then, through the February 1 week, they've raised their 2018 earnings estimates for the S&P 500/400/600 by \$9.00, \$5.30, and \$2.81 per share, resulting in expected growth rates of 17.3%, 20.8%, and 25.4%.

The estimates for each of the current year's quarterly earnings for the three market-cap indexes all have been raised significantly ([Fig. 10](#)). Double-digit growth rates on a y/y basis are now expected across the board through the end of this year ([Fig. 11](#)).

Forward earnings for all three S&P market caps are rising faster than their corresponding forward revenues ([Fig. 12](#)). As a result, forward profit margins have soared since the TCJA was passed ([Fig. 13](#)). However, during the current earnings season, most company managements have said that they intend to spend some of their tax windfalls in ways that might keep a lid on profit margins.

Strategy III: Effective Tax Rate Math. While the upward revisions in earnings estimates since TCJA passage are impressive, they confirm our view that the effective corporate tax rate was well below the statutory 35% before it was slashed by 40% to 21%. We did the math at the beginning of last week using \$7 per share as the earnings windfall to the S&P 500. Let's update the analysis using \$9 per share, which is a 6% earnings windfall. Joe and I estimate that Q4-2017 aggregate earnings for the S&P 500 was \$1.2 trillion at an annual rate. So that implies that S&P 500 corporations' tax bill will be lower by \$72 billion this year. Last year, they paid \$283 billion in federal corporate income taxes. This implies a 25% cut in the effective tax rate. That's still a substantial windfall.

CALENDARS

US. Tues: Merchandise Trade Balance -\$51.9b, Job Openings 5.900m. **Wed:** Consumer Credit \$20.0b, MBA Mortgage Applications, EIA Petroleum Status Report, Williams, Dudley. (*Wall Street Journal* estimates)

Global. Tues: German Factory Orders 0.7%/m/m/3.1%/y/y, RBA Cash Target Rate 1.50%. **Wed:** Germany Industrial Production -0.5%/m/m/6.8%/y/y, Japan Leading & Coincident Indexes 108.1/120.5, Japan Trade Balance (yen) 514.3b. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings surged to yet more record highs last week for all three indexes as more analysts incorporated the lower tax rate into their models. LargeCap's forward earnings was higher for a 28th straight week; MidCap's was higher for a 24th week; and SmallCap's has risen in 22 of the past 28 weeks. Momentum remains strong, as the yearly change in forward earnings is up from six-year lows in early 2016 and should accelerate in 2018. In the latest week, the rate of change in LargeCap's forward earnings surged to 17.5% y/y from 15.5%, which is its highest since August 2011 and compares to a six-year low of -1.8% in October 2015; MidCap's jumped to 21.9% from 20.9%, which is the highest since July 2011 and compares to a six-year low of -1.3% in December 2015; and SmallCap's rose to 18.1% from 16.7%, which is the highest since October 2011 and compares to a six-year low of 0.3% in December 2015. Consensus growth rates expected for 2018 improved w/w for all three indexes. Here are the latest consensus earnings growth rates for 2017 and 2018: LargeCap 12.2% and 17.3%, MidCap 10.5% and 20.8%, and SmallCap 6.3% and 25.4%.

S&P 500/400/600 Forward Valuation ([link](#)): Forward P/E ratios tumbled about a full point for the three indexes last week to their lowest levels since early September. LargeCap's weekly forward P/E dropped to 17.6 from 18.6, which was the highest since May 2002. That's up from a 15-month low of 14.9 in January 2016 and the post-Lehman-meltdown P/E of 9.3 in October 2008, but remains well below the tech bubble's record high of 25.7 in July 1999. MidCap's forward P/E dropped to 17.4 from 18.3, and has been at or below LargeCap's P/E since August for the first time since 2009. MidCap's P/E remains below its 15-year high of 19.2 in February 2017, when the Energy sector's earnings were depressed, and the record high of 20.6 in January 2002, but is up from a three-year low of 15.0 in January 2016. SmallCap's P/E fell to 18.8 from 19.8, which compares to a 51-week high of 20.2 at the beginning of December and a 15-year high of 20.5 in December 2016, when Energy's earnings were depressed. That's up from a three-year low of 15.5 in February 2016, and just 0.9ppt below SmallCap's record-high P/E of 20.9 in April 2002. Looking at their daily forward price/sales (P/S) ratios, valuations also fell last week for the three indexes: LargeCap's P/S slipped to 2.11 from a record high of 2.19, MidCap's fell to 1.34 from a record high of 1.40, and SmallCap's 1.05 was down from 1.09 a week earlier, which remains below its record high of 1.17 in November 2013 when Energy revenues were depressed.

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, our focus is now on the revision activity for the Q1-2018 earnings forecasts. The S&P 500's Q1-2018 EPS forecast rose w/w to \$36.01 from \$35.83. That's up 4.6% since the end of Q4 and 5.3% since the passage of the TCJA. The \$35.83 estimate represents a forecasted pro forma earnings gain for Q1-2018 of 17.7%, up from 16.7% a week earlier, and compares to Q4-2017's blended 13.6%, 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 unchanged for one. Energy's Q1 forecast has jumped 19.4%, followed by the forecasts for Financials (up 10.6%), Telecom (7.7%), and Consumer Discretionary (5.6). Real Estate's Q1-2018 forecast is unchanged, followed by small gains for Tech (0.6), Utilities (1.3), Consumer Staples (2.6), Materials (3.3), Industrials (3.4), and Health Care (3.8). The S&P 500's Q1-2018 forecasted earnings gain of 17.7% 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 the expectation for Q4-2017 of 10 sectors rising y/y. All 11 sectors last rose y/y during Q2-2017, which was the first time that had happened since Q3-2011. The latest forecasted Q1-2018 earnings growth rates vs their blended Q4-

2017 growth rates: Energy (76.6% in Q1-2018 vs 110.2% in Q4-2017), Materials (25.9, 32.8), Financials (23.3, 14.7), Tech (20.6, 18.4), S&P 500 (17.7, 13.6), Telecom (13.9, 6.2), Industrials (13.0, 6.9), Consumer Staples (11.9, 10.6), Consumer Discretionary (10.7, 5.5), Health Care (10.1, 7.2), Utilities (6.1, 7.8), and Real Estate (5.1, -2.5). On an ex-Energy basis, S&P 500 earnings are expected to rise 15.7% y/y in Q1, up from a blended 11.7% 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 over 51% 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 256 companies in the S&P 500 that have reported, 79% exceeded industry analysts' earnings estimates by an average of 4.3%; they have averaged a y/y earnings gain of 16.1%. At the same point during the Q3-2017 reporting period, a lower percentage of companies (75%) in the S&P 500 had beaten consensus earnings estimates by a higher 5.0%, and earnings were up a lower 9.5% y/y. On the revenue side, 81% beat sales estimates so far, with results coming in 1.3% above forecast and 10.4% higher than a year earlier. At this point in the Q3 season, a lower 66% had exceeded revenue forecasts by a higher 1.6%, and sales had risen by a lower 6.6% y/y. Q4 earnings results are higher y/y for 80% of companies vs a lower 74% at the same point in Q3, and revenues are higher y/y for 90% during Q4 vs a lower 83% a quarter ago. These figures will continue to change 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 not surprised to see that metric weaken 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.

GLOBAL ECONOMIC INDICATORS

Global Composite PMIs ([link](#)): Global economic activity in January reached a 40-month high on broad-based strength. The J.P. Morgan Global Composite Output Index (C-PMI) climbed for the fourth straight month, from 53.8 in September to 54.6 in January—its best reading since September 2014. The M-PMI (to 54.4 from 54.5) was little changed from December's near seven-year high, while the NM-PMI (54.1 from 53.8) was back up at recent highs. Manufacturing activity has outpaced services activity by a small margin the past couple of months, after lagging behind for several years. Developed markets (54.9 from 54.8) continued to outperform emerging markets (53.6 from 53.0), though the latter is playing catch-up, accelerating sharply the past two months. The Eurozone C-PMI (58.8) expanded at its best pace since June 2006 last month, with growth accelerating in Germany (59.0, 81-month high), Italy (59.0, 139-month high), and Spain (56.7, six-month high), while France's (59.6) was at the top of the leader board, unchanged around recent highs; growth slowed in Ireland (59.0 from 60.2) but remained robust. Rates of expansion also improved in China (53.7 from 53.0) and Japan (52.8 from 52.2), while Brazil's (50.7 from 48.8) swung from contraction to expansion. Meanwhile, C-PMIs showed an easing of growth in the US (53.8 from 54.1), UK (53.5 from 54.9), India (52.5 from 53.0), and Russia (54.8 from 56.0).

Global Non-Manufacturing PMIs ([link](#)): Global service-sector growth accelerated into 2018. J.P. Morgan's NM-PMI recovered for the second month from 53.7 in November to 54.1 in January—back up at October's 26-month high. Last month, the Eurozone NM-PMI (to 58.0 from 56.6) revealed the service sector grew at its fastest pace in over a decade, led by stronger growth in France (59.2 from 59.1), Germany (57.3 from 55.8), Italy (57.7 from 55.4), and Spain (56.9 from 54.6); Ireland's (59.8 from 60.4) growth slowed slightly, though still outpaced the top four Eurozone economies. Outside the Eurozone, NM-PMIs accelerated in China (54.7 from 53.9), Japan (51.9 from 51.1), and India (51.7 from 50.9)—with China's at a 68-month high. NM-PMIs for the US (53.3 from 53.7), UK (53.0 from 54.2), and Russia (55.1 from 56.8) showed a slowing in service sector growth, while Brazil's (50.0) stabilized after

contracting the prior three months.

US Non-Manufacturing PMIs ([link](#)): The US service sector in January accelerated at its fastest pace since August 2005, according to the ISM survey, while it grew at its slowest pace in nine months according to Markit's. ISM's NM-PMI jumped from 56.0 to 59.9 last month on widespread strength. Three of the four components accelerated, while the supplier deliveries index was unchanged at 55.5. The new orders (to 62.7 from 54.5) and employment (61.6 from 56.3) indexes both jumped above 60.0—the latter for the first time since 2005; meanwhile, the business activity (59.8 from 57.8) gauge is heading back up toward 60.0 after dipping below in December. Markit's NM-PMI eased for the third month, from 55.3 in October to 53.3 in January—the lowest since last April. While output softened, new business expanded at its best pace since September 2017 and job creation remained solid.

Eurozone Retail Sales ([link](#)): December retail sales retreated from November's record high. Sales sank 1.1% after jumping a revised 2.0% in November—which was stronger than the initial 1.5% gain. December's setback was widespread, with spending on automotive fuel (-1.5%), non-food products (-1.2), and food, drinks & tobacco (-0.7) all in the red, though the latter two remain in record territory; it was the fifth decline in six months for automotive fuel. Available data for three of the Big Four economies show sales fell in December after big November gains. German spending dropped 1.9%—reversing November's 1.9% gain—while sales in France and Spain fell 0.8% and 0.6%, respectively, after jumping 3.3% and 1.2% the prior month. Sales in Germany and France remain just shy of their record highs. Along with Germany, the biggest sales declines were recorded in Luxembourg (-6.2), Ireland (-2.7), Slovenia (-2.3), and Austria (-1.8); Malta (3.1) and Estonia (1.8) posted the biggest gains.

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