



MORNING BRIEFING

February 13, 2018

Huge Jump in Earnings

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

(1) Analysts now saying TCJA adding \$11-\$12 per share to S&P 500 earnings this year. (2) Joe says \$14-\$15 is likely. (3) Earnings meltup should trump P/E meltdown. (4) Even revenue estimates seem to have gotten a big TCJA boost. (5) Raising our 2018 and 2019 S&P 500 earnings estimates to \$155 and \$166 based on trend growth plus TCJA bump. (6) Following TCJA upward earnings revisions, earnings forecasts should resume usual downward drift. (7) Sticking with 3100 year-end forecast for S&P 500 thanks to strong earnings tailwind. (8) Lots of upbeat earnings indicators.

Strategy I: Big Deal for Earnings. The S&P 500 peaked at a record high of 2872.87 on January 26. It plunged 10.2% through last Thursday's close ([Fig. 1](#)). While stock prices swooned, industry analysts continued to raise their earnings estimates for the S&P 500 to reflect the impact of the Tax Cut and Jobs Act (TCJA) passed on December 22 ([Fig. 2](#)). Since then, over the past eight weeks through the week of February 8, they've increased their 2018 estimates by \$10.62 to \$156.88 per share. Their consensus estimate for 2019 is up \$11.60 to \$172.67 over the same period. In the past, the weekly "Earnings Squiggles" have had a downward bias, which will probably resurface for 2018 and 2019 once the tax cut is fully reflected in earnings estimates ([Fig. 3](#)). Surprisingly, even the 2018 growth rate in S&P 500 revenues per share on a y/y basis has increased from 5.6% just before TCJA to 6.2% last week ([Fig. 4](#)).

In other words, while the stock market had a January meltup followed by a February meltdown, earnings estimates continued to melt up. That was because industry analysts have received very upbeat guidance on the earnings impacts of the TCJA from company managements since Q4 earnings reporting began at the start of this year. The recent divergence between soaring earnings estimates for the S&P 500/400/600 and their plummeting stock price indexes has been remarkable, as shown by our Blue Angels analysis ([Fig. 5](#)).

As we have previously noted, it's not clear why the outlook for revenues growth improved for this year following the passage of TCJA, unless many industry analysts have suddenly turned into supply-side economists believing that lower tax rates will boost economic growth. Of course, the global economic outlook has started to improve since late 2016, and the trade-weighted dollar has been weak over this period. Both factors will boost both revenues and earnings growth rates for the S&P 500. However, both factors have been working to do so for at least a year before TCJA was passed.

Joe and I have been mightily impressed by the boost to earnings from the TCJA. So far, it is turning out to be almost twice what we expected. We believe that the meltup in earnings estimates should limit the recent meltdown in the S&P 500's forward P/E, which dropped from a recent high of 18.6 on January 26 to a low of 16.3 on February 8 ([Fig. 6](#)). Actually, the rapidly rising outlook for earnings should revive valuation multiples, and may have started to do so late last Friday.

In any event, we need to raise our outlook for S&P 500 earnings during 2018 and 2019. Here's our latest thinking on the subject:

(1) *Baseline assuming no TCJA.* For starters, let's consider the underlying trend in earnings. The trend annual growth rate in S&P 500 reported earnings since 1935 has ranged between 5% and 7% ([Fig. 7](#)). In our work, Joe and I give more weight to S&P 500 forward earnings, the time-weighted average of analysts' consensus earnings estimates for the current year and the coming year. It has fluctuated around a 7% trendline since the late 1970s ([Fig. 8](#)).

We estimate that S&P 500 operating earnings per share totaled \$132 last year. A 7% growth rate would raise it to \$141 in 2018 and \$151 in 2019.

(2) *Earnings with TCJA.* Joe reminds us that the earnings season isn't over and that the consensus estimate for the impact of TCJA on S&P 500 earnings could rise from \$11-\$12 currently to \$14-\$15 once all the companies have reported and provided guidance.

So we are penciling in a 2018 forecast of \$155. For next year, based on a 7% growth rate, we are using \$166. These are significant upward revisions for us. We don't think they've been reflected in the market, certainly not during the recent correction. Indeed, the consensus 2018 estimate of the 10 investment strategists (including yours truly) [surveyed](#) last year in the 12/9 *Barron's* was \$145.

(3) *Reconciling us with them.* The latest 2018 and 2019 analysts' consensus estimates are even higher than our latest forecasts. Analysts tend to be too optimistic about the future prospects for their companies. That's why there is usually a downward drift in their estimates for both the level and the growth of earnings as they converge to actual results ([Fig. 9](#) and [Fig. 10](#)).

Analysts are currently projecting \$156.88 for 2018 and \$172.67 for 2019. Once they've all incorporated the impact of TCJA on their companies by the end of the current earnings season, the downward drift should begin. Their 2018 numbers should decline toward our current estimate as the year progresses, assuming we are on target. In any case, all of our estimates will converge to the actual results by the end of this year.

However, the analysts' 2019 estimate, which should soon start drifting lower, may very well still exceed our forecast for 2019 at the end of this year. It is their estimate that will be discounted in the market, not ours. That's based on our view that the market discounts forward earnings, which will be the same as analysts' consensus expectations for 2019 at the end of this year. (We hope you are still following our drift on all of this!)

Strategy II: Big Tailwind for Stocks. Now the fun begins in earnest: What does the outlook for earnings imply for the S&P 500 stock price index by the end of the year? The bottom line is that we are sticking with our forecast of 3100, which would be a 16.7% increase from yesterday's close. Our target is based on our 2019 earnings estimate of \$166 multiplied by a forward P/E of 18.7. Our earnings outlook provides a big tailwind for this bullish forecast.

If the P/E seems high, particularly after the recent P/E meltdown from 18.6 on January 26 to a low of 16.3 on February 8, keep in mind that the market will probably be discounting the analysts' 2019 forecast at the end of this year, which is likely to be higher than our estimate.

Strategy III: Lots of Upbeat Earnings Indicators. While valuation multiples have swooned during the latest correction, earnings indicators have been uniformly bullish. Above, Joe and I reviewed the major ones. There are plenty more. Consider the following:

(1) *Revenues.* S&P 500/600/400 forward revenues are all on uptrends in record-high territory ([Fig. 11](#)).

Looking at the 2018 revenue forecast, they are up 1.3%, 0.4%, and 0.2%, respectively. Only the S&P 500 revenues series seems to have gotten a TCJA boost.

(2) *Profit margins*. S&P 500/400/600 forward profit margins have all gotten big TCJA boosts ([Fig. 12](#)).

(3) *Quarterly earnings estimates*. There has been a typical earnings season upside hook for Q4-2017, with the actual growth rate at 14.8% y/y, up from the 11.4% increase expected just before the latest season started. That's nothing compared to the upward revisions in the y/y growth rates now expected for each of this year's four quarters for the S&P 500/400/600. All 12 of these growth rates are expected to be in the double digits this year ([Fig. 13](#) and [Fig. 14](#)).

CALENDARS

US. Tues: NFIB Small Business Optimism Index 105.8, Mester. **Wed:** Retail Sales Total, Ex Autos, Ex Autos & Gas, and Control Group 0.3%/0.5%/0.4%/0.4%, Business Inventories 0.2%, Headline & Core CPI 2.0%/1.7% y/y, Atlanta Fed Business Inflation Expectations, MBA Mortgage Applications, EIA Petroleum Status Report. (*Wall Street Journal* estimates)

Global. Tues: UK Headline & Core CPI 2.9%/2.6% y/y, Japan GDP (annualized) 1.0% q/q, Japan Machine Tool Orders. **Wed:** Eurozone Industrial Production 0.1% m/m/4.2% y/y, Eurozone GDP 0.6% q/q/2.7% y/y, Germany GDP 0.6% q/q/3.0% y/y, Italy GDP 0.4% q/q/1.7% y/y, Germany CPI - 0.7% m/m/1.6% y/y, Japan Machine Orders -2.3% m/m/1.8% y/y. (DailyFX estimates)

STRATEGY INDICATORS

YRI Weekly Leading Index ([link](#)): Our Weekly Leading Index (WLI)—a good coincident indicator that can confirm or raise doubts about stock market swings—climbed 8.5% during the four weeks ending February 3 to yet another new record high. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). Our BBB also reached a new record high, jumping 14.6% over the four-week period, as jobless claims—one of the components of our BBB—plunged from 250,750 to 224,500 (4-wa) over the time span to its lowest reading since March 10, 1973! Meanwhile, the CRB raw industrial spot price index, another BBB component, is down from recent highs. The WCCI remains on a steep uptrend.

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 29th straight week; MidCap's was higher for a 25th week; and SmallCap's has risen in 23 of the past 29 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 19.0% y/y from 17.5%, which is its highest since June 2011 and compares to a six-year low of -1.8% in October 2015; MidCap's jumped to 23.5% from 21.9%, which is the highest since May 2011 and compares to a six-year low of -1.3% in December 2015; but SmallCap's edged down to 18.0% from 18.1%, which was 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 2018 and 2019: LargeCap 18.5% and 10.1%, MidCap 21.4 and 11.2%, and SmallCap 25.3% and 14.7%.

S&P 500/400/600 Forward Valuation ([link](#)): Forward P/E ratios tumbled about a full point for a second straight week for these three indexes to their lowest levels since early September. LargeCap's weekly forward P/E dropped to a post-election low of 16.5 from 17.6, and is down 11% from 18.6 the week

prior, 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 a 23-month low of 16.3 from 17.4, and has been at or below LargeCap's P/E since August for the first time since 2009. MidCap's P/E is down 15% from 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 17.8 from 18.8 the week before; the drop puts the P/E down 12% from its 51-week high of 20.2 in December (which wasn't much below the 15-year high of 20.5 in December 2016, when Energy's earnings were depressed) but up from its three-year low of 15.5 in February 2016. Looking at their daily forward price/sales (P/S) ratios on Thursday, valuations also fell last week for the three indexes: LargeCap's P/S tumbled to 1.95 from 2.14 and is down from a record high of 2.19 on January 26. MidCap's fell to 1.29 from a record high of 1.40, and SmallCap's 0.99 was down from 1.07 a week earlier, which remains below its record high of 1.17 in November 2013 when Energy revenues were depressed.

S&P 500 Q4 Earnings Season Monitor ([link](#)): With over 68% of S&P 500 companies finished reporting earnings and revenues for Q4-2017, their revenue and earnings surprise metrics are mostly better compared to the same point during the Q3 earnings season. Of the 342 companies in the S&P 500 that have reported through mid-day Wednesday, 78% exceeded industry analysts' earnings estimates by an average of 4.9%; they have averaged a y/y earnings gain of 16.9%. 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 slightly higher 5.1%, and earnings were up a lower 8.9% y/y. On the revenue side, 79% beat sales estimates so far, with results coming in 1.3% above forecast and 9.1% higher than a year earlier. At this point in the Q3 season, a lower 67% had exceeded revenue forecasts by a higher 1.5%, and sales had risen by a lower 6.5% y/y. Q4 earnings results are higher y/y for 80% of companies vs a lower 72% at the same point in Q3, and revenues are higher y/y for 88% during Q4 vs a lower 82% a quarter ago. These figures will continue to change as more Q4-2017 results are reported in the coming weeks. Q4's 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.

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