MORNING BRIEFING
February 27, 2018

Earnings Are Great Again

See the collection of the individual charts linked below.

(1) Earnings in outer space. (2) Earnings were on course to be great again before Trump, and now will be even greater after TCJA. (3) Revenues growth above 9% y/y during Q4. (4) Forward revenues at record high. (5) Double-digit earnings growth during 2017 will be followed by more of the same in 2018. (6) Forward earnings signaling $160 per share in 2018. (7) Profit margin rose to new record high during Q4, and that was before TCJA will push it higher! (8) Lots of new record highs for revenues and earnings among the 11 sectors of the S&P 500.

Strategy I: Booster Rocket. The Tax Cut and Jobs Act's (TCJA) cut in the corporate statutory tax rate at the end of 2017 will send earnings hurtling beyond the Earth's gravitational pull this year into outer space.

They were heading in that direction last year. It's conceivable that some of last year's earnings extravaganza was attributable to the Trump administration's easing of regulatory costs. More likely is that 2017 earnings were boosted by the synchronized global economic expansion that followed the worldwide energy-led global growth recession from 2014 through 2016. Joe and I started to see signs of a global recovery during the summer of 2016, which led us to conclude that stock prices were likely to head higher no matter who won the presidential race on November 8, 2016. Trump won on his campaign promise to "Make America Great Again." Earnings were on course to be great again, in any event, and now they will be even greater thanks to the TCJA.

That simple insight led Joe and me to conclude that the meltdown in the stock market in early February was a flash-crash correction that would be short-lived given the meltup in actual and expected earnings. We now have the results for S&P 500 earnings during Q4-2017. They were HUGE. Consider the following:

(1) *Revenues*. S&P 500 revenues rose to a record high of $329.41 per share at the end of last year (*Fig. 1*). Remarkably, revenues per share rose 9.4% y/y, the fastest since Q3-2011 (*Fig. 2*). Needless to say, it's hard to imagine that this fast pace was boosted by anything that can be traced to the White House, especially since almost half of S&P 500 revenues come from abroad. In the US, nominal GDP was up 4.4% y/y during Q4, lagging the 8.5% growth in S&P 500 aggregate revenues (*Fig. 3*).

On the other hand, the trade-weighted dollar fell 7.0% y/y last year, which must have boosted revenues (*Fig. 4*). As Debbie and I previously observed, the dollar tends to be weak when the global economy is doing well and commodity prices are rising (*Fig. 5*).

We aren't that surprised by the strength in revenues at the end of last year. That's because it was clearly signaled by the weekly S&P 500 forward revenues series, which is the time-weighted average of industry analysts' consensus expectations for revenues during the current year and the coming year (*Fig. 6*). It continues to rise in record-high territory.

(2) *Earnings.* We also aren't surprised that S&P 500 operating earnings per share jumped 15.3% y/y

during Q4-2017 according to Thomson Reuters (*Fig. 7* and *Fig. 8*). Nevertheless, we are certainly impressed. S&P also compiles operating earnings for the S&P 500 operating earnings using a more conservative approach for one-time nonoperating gains and losses (*Fig. 9*). This measure rose even more impressively, with a 22.3% y/y gain.

Interestingly, S&P 500 reported earnings dropped sharply during Q4-2017, and was basically flat compared to a year ago. Weighing on earnings during the last quarter of 2017 were charges related to the TCJA, such as a substantial drop in the value of deferred tax assets given that the corporate tax rate was cut from 35% to 21%.

Again, we aren't surprised by the strength in earnings. It was clearly signaled by the weekly S&P 500 forward operating earnings (*Fig. 10*). The four-quarter sum of S&P 500 operating earnings per share (based on the Thomson Reuters data) was $133 last year. The forward earnings series suggested in late February that earnings are headed toward $160 per share this year. That would be a 20% jump.

At the end of February, the analysts' consensus earnings estimate for 2018 was actually $157.92, a 19.1% y/y gain. Joe and I are currently forecasting $155.00, a 16.8% increase. In any event, earnings will be up HUGEly this year.

(3) *Profit margin.* Now let's take a moment to remember all those growling bears who have been trampled by the stampeding bulls since 2009. Joe and I miss them. We would have more confidence in the longevity of the bull market if they were still growling (as they mostly did from 2009-2013) that the bull market was on a sugar high and that earnings would be disappointing, or that the profit margin would soon revert to its mean.

The flash crash a few weeks ago might have given the bears a reason for living, but it was too short-lived. And here's another disappointing flash for the bears: The operating profit margin of the S&P 500 rose to a new record high during Q4 (*Fig. 11*). It was 11.0% based on Thomson Reuters data and 10.4% based on S&P data.

Strategy II: Sectors' Q4 Revenues and Earnings. I asked Joe to put on his diving suit and find out what revenues and earnings did during Q4-2017 for the 11 sectors of the S&P 500. He reports as follows:

(1) *Sector revenues*. Six of the sectors had record revenues during the quarter: Consumer Discretionary, Consumer Staples, Financials, Health Care, Industrials, and Information Technology (*Fig. 12*).

Here is the sectors' performance derby for y/y revenues growth rates: Energy (29.1%), Information Technology (15.2), Materials (10.9), Consumer Staples (10.4), Financials (9.8), S&P 500 (9.4), Industrials (8.5), Health Care (5.8), Utilities (5.7), Consumer Discretionary (5.4), Telecommunication Services (-1.6), and Real Estate (-5.1).

(2) *Sector earnings.* Four of the sectors had record-high earnings based on Thomson Reuters data: Consumer Discretionary, Consumer Staples, Financials, and Information Technology (*Fig. 13*).

Here is the sectors' performance derby for y/y earnings growth: Energy (123.7%), Information Technology (19.5), Financials (15.9), S&P 500 (15.3), Consumer Staples (14.2), Consumer Discretionary (11.6), Utilities (10.0), Industrials (9.0), Health Care (7.9), Telecommunication Services (7.5), Materials (0.6), and Real Estate (-9.4).

CALENDARS

US. Tues: Durable Goods Orders, Total, Ex Transportation, and Core Capital -2.0%/0.4%/0,6%, Consumer Confidence 126.0, Advance Merchandise Trade Balance -$71.3b, Richmond Fed Manufacturing Index 15.5, S&P Case-Shiller Home Price Index 0.7%m/m/6.3%y/y, FHFA Price Index 0.5%, Wholesale Trade Inventories 0.2%, Powell. **Wed:** Real GDP & PCE 2.5%/3.7%, GDP Price Index 2.4%, Pending Home Sales 0.5%, MBA Mortgage Applications, Chicago PMI 65.0, EIA Petroleum Status Report. (*Wall Street Journal* estimates)

Global. Tues: Eurozone Economic Confidence 114.0, Germany CPI 0.5%m/m/1.5%y/y, Japan Industrial Production -4.2%m/m/5.2%y/y, Japan Retail Trade -0.6%m/m/2.5%y/y. **Wed:** Germany Unemployment Change & Unemployment Rate -15k/5.4%, Germany Gfk Consumer Confidence 10.9, France GDP 0.6%q/q/2.4%y/y, UK Gfk Consumer Confidence -10, Japan Housing Starts 940k, China M-PMI & NM-PMI 51.2/55.0. (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 31st straight week; MidCap's was higher for a 27th week; and SmallCap's has risen in 25 of the past 31 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 rose to 19.9% y/y from 19.6%, which is its highest since May 2011 and compares to a six-year low of -1.8% in October 2015; MidCap's improved to 23.9% from 23.5%, which is the highest since April 2011 and compares to a six-year low of -1.3% in December 2015; and SmallCap's increased to 20.3% from 19.3%, which was the highest since September 2011 and compares to a six-year low of 0.3% in December 2015. Consensus expected earnings for 2018 improved w/w for all three indexes, albeit at the slowest rate since the passage of the TCJA. Here are the latest consensus earnings growth rates for 2018 and 2019: LargeCap 19.1% and 10.0%, MidCap 20.5% and 11.6%, and SmallCap 24.2% and 14.7%.

S&P 500/400/600 Forward Valuation (*link*): Last week saw forward P/E ratios hold steady w/w for LargeCap and MidCap, and edge down for SmallCap, but all have improved about 5% from their February 8 lows. LargeCap's weekly forward P/E of 17.1 is up from a post-election low of 16.3, which compares to 18.6 on January 26—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 of 17.0 is up from the panic attack's 23-month low of 16.2, but has been at or below LargeCap's P/E since August for the first time since 2009. MidCap's P/E is down from a 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 edged down w/w to 18.3 from 18.4, which compares to a post-election low of 17.6. SmallCap's P/E remains well below 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 is comfortably above its three-year low of 15.5 in February 2016. Looking at their daily forward price/sales (P/S) ratios on Friday, valuations ticked up 0.1ppt last week for the three indexes: LargeCap's P/S of 2.07 is down from a record high of 2.19 on January 26, MidCap's 1.36 remains below its record high of 1.40, and SmallCap's 1.05 compares to 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 beginning to wind down, the focus is squarely on the revision activity for the Q1-2018 earnings forecasts. The S&P 500's

Q1-2018 EPS forecast rose w/w to $36.24 from $36.18. That's up 5.3% since the end of Q4 and 6.0% since the passage of the TCJA. The $36.24 estimate represents a forecasted pro forma earnings gain for Q1-2018 of 18.2%, up from 18.0% a week earlier, and compares to Q4-2017's blended 15.3%, Q3-2017's 8.5%, Q2-2017's 12.3%, and Q1-2017's 15.3% (which then 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 down for one. Energy's Q1 forecast has jumped 21.7%, followed by the forecasts for Telecom (up 14.4%), Financials (11.9), and Consumer Discretionary (5.6). Real Estate's Q1-2018 forecast is down 4.3%, followed by small gains for Materials (0.7), Consumer Staples (0.8), Tech (1.7), Consumer Discretionary (4.2), Industrials (4.3), Utilities (4.3), and Health Care (4.7). The S&P 500's Q1-2018 forecasted earnings gain of 18.2% y/y would be its seventh straight gain after four declines and its strongest since Q1-2011. 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 18.2%. 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 (76.3% in Q1-2018 vs 121.3% in Q4-2017), Materials (27.6, 35.6), Financials (23.9, 15.4), Tech (22.0, 20.0), S&P 500 (18.2, 15.3), Industrials (14.5, 7.5), Telecom (13.6, 4.8), Health Care (10.5, 8.4), Utilities (10.1, 11.5), Consumer Staples (9.9, 12.1), Consumer Discretionary (9.1, 9.8), and Real Estate (4.0, -2.6). On an ex-Energy basis, S&P 500 earnings are expected to rise 16.2% y/y in Q1, up from a blended 13.1% 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 91% 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. Q4-2017 will mark the sixth straight quarter of positive y/y earnings growth and the seventh straight quarter of positive y/y revenue growth, as well as the quarter with the highest y/y revenue and earnings growth since Q3-2011. Of the 453 companies in the S&P 500 that have reported through mid-day Tuesday, 76% exceeded industry analysts' earnings estimates by an average of 4.8%; they have averaged a y/y earnings gain of 16.6%. At the same point during the Q3-2017 reporting period, a lower percentage of companies (73%) in the S&P 500 had beaten consensus earnings estimates by a higher 5.5%, and earnings were up a lower 8.1% y/y. On the revenue side, an impressive 77% beat sales estimates so far, with results coming in 1.3% above forecast and 8.2% higher than a year earlier. At this point in the Q3 season, a lower 67% had exceeded revenue forecasts by a similar 1.3%, and sales had risen by a lower 5.9% y/y. Q4 earnings results are higher y/y for 78% of companies vs a lower 70% at the same point in Q3, and revenues are higher y/y for 87% during Q4 vs a lower 79% a quarter ago. The percentages of companies growing y/y are the highest since we first began tracking them during Q1-2009.

US ECONOMIC INDICATORS

New Home Sales (*link*): New home sales in January fell for the second time since reaching a new cyclical high in November—likely weighed down by wintery weather in the Northeast and South. January sales fell 7.8% to a five-month low of 593,000 units (saar) following a revised 7.6% decline in December—which was less negative than the initial 9.3% loss; sales had jumped two of the prior three months by 24.5% to a cyclical high of 696,000 units. (New home sales are tabulated when contracts are signed, making new home sales a timelier barometer of the residential market than existing home sales.) Sales in the Northeast tumbled 33.3% in January and 41.5% over the two-month period, with sales in the South (which accounts for half the market) sinking 14.3% and 19.9% over the comparable periods. In January, there were 301,000 homes on the market—the most since March 2009, with the supply of homes at the current sales rate climbing for the second month, from 4.9 in November to 6.1

last month. Meanwhile, builders' confidence remained high in February, and their confidence in future sales expectations reached a post-recession high, according to the NAHB Housing Market Index. Builders' confidence held at 72 this month, a slight dip from 74 in December, which was an 18-year high. The components were mixed: Sales expectations over the next six months climbed 2 points to a post-recession high of 82, while the measure for current sales conditions dropped a point for the second month, to 78, after hitting a cyclical high of 80 at the end of last year; the index measuring buyer traffic held steady at 54.

Regional M-PMIs (*link*): Four Fed districts have now reported on manufacturing activity for this month—New York, Philadelphia, Kansas City, and Dallas—and they show growth in the sector remains robust. We average the composite, orders, and employment measures as data become available. The composite index accelerated from 22.3 to 23.3 this month, driven by the best growth in the Dallas (to 37.2 from 33.4) region since the end of 2004. Meanwhile, the Philadelphia (25.8 from 22.2) and Kansas City (17 from 16) regions showed a slight pickup in growth, while New York's (13.1 from 17.7) showed a slight easing. The new orders gauge (19.8 from 15.4) improved, led by an acceleration in the Philly (24.5 from 10.1) region; growth in the Dallas (25.3 from 25.5), Kansas City (16 from 14) and New York (13.5 from 11.9) regions all were close to January's pace. The employment measure climbed from 13.5 to 19.6 this month, heading back toward its recent peak of 21.1 in October. Manufacturers in all four regions—Philly (25.2 from 16.9), Kansas City (23 from 18), Dallas (19.1 from 15.2), and New York (10.9 from 3.8)—added to payrolls at a faster pace.

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