



MORNING BRIEFING

February 28, 2018

Giddy Up!

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

(1) Mini-version of 1987. (2) Déjà vu all over again. (3) Updating the bullish impact of TCJA on earnings. (4) Giddy talk on CNBC resulting from giddy talk during latest earnings season conference call. (5) Melissa tunes in to the conference calls of the 30 DJIA corporations. (6) "[D]oggone good!" (7) Tax reform making US companies more competitive, with greater "capital flexibility." (8) TCJA windfall likely to boost capital spending, buybacks, dividends, and employee benefits. (9) Lots of talk about funding organic growth rather than M&A.

Strategy I: Gushing Over Earnings. The latest stock market correction was a mini-version of the 1987 crash. Back then, the DJIA rose 50.5% after the passage of Reagan's tax reform plan on October 22, 1986 through August 25, 1987 ([Fig. 1](#)). It did so despite a significant increase in the 10-year Treasury bond yield from a 1987 low of 7.01% on January 21 to that year's high of 10.23% on October 16 ([Fig. 2](#)). The bull market ended badly on Black Monday, October 19, when the DJIA plunged 22.6%. The index had already started to weaken in response to soaring bond yields. However, it began to come unglued the week before Black Monday, when the House Ways and Means Committee proposed to eliminate a tax break that had been stimulating M&A activity. The actual crash was widely attributed to so-called "portfolio insurance" algorithms that went berserk.

If all this sounds familiar to you, it might be because I wrote about it on January 29 of this year in the [Morning Briefing](#) titled "Don't Worry, Be Wealthy." Notwithstanding the happy title, the third section of that piece was titled "1987 All Over Again?" I reiterated a point I had made in the 10/9/17 [Morning Briefing](#): "By the way, a meltup followed by a meltdown won't necessarily cause a recession. It might be more like 1987, creating a great buying opportunity, assuming that we raise some cash at the top of the melt-up's ascent."

As it turned out, the DJIA hit a record high on January 26 and proceeded to fall 10.4% through February 8. Since then, it is up 7.7% through Monday's close. Back in 1987, the House Ways and Means Committee buried its proposal to eliminate the M&A tax break during December, which set the stage for the great bull market that lasted through the start of 2000. Helping to revive the stock market back then during late 1987 was the fact that earnings continued to make new highs as the valuation multiple plunged ([Fig. 3](#) and [Fig. 4](#)).

During the latest correction, the sharp decline in valuation multiples occurred just as industry analysts were scrambling to raise their earnings estimates significantly for 2018 following the 12/22 enactment of the Tax Cut and Jobs Act (TCJA). Joe and I have been monitoring them closely. Here is a quick update:

(1) *Revenues and earnings.* While it is hard to see a direct link between the TCJA and S&P 500 revenues, industry analysts have raised their consensus estimate for 2018 by 1.7% over the past nine weeks through February 15 ([Fig. 5](#)). Their estimate for earnings has jumped by 7.7%, or \$11.05 per share, from \$143.85 to \$154.90 ([Fig. 6](#)).

(2) *Growth rate*. Industry analysts have raised their 2018 earnings growth estimate from 11.4% before the TCJA to 19.2% currently ([Fig. 7](#)). Their estimate for 2019 is 10.3%.

(3) *Net Earnings Revisions*. The S&P 500 Net Earnings Revisions Index (NERI) jumped to 21.0% during February, the highest positive reading since the start of the data in 1985 ([Fig. 8](#)). Here is the performance derby for the NERIs of the 11 sectors of the S&P 500: Financials (33.1%), Industrials (27.8), Energy (26.8), Consumer Staples (25.2), Telecom (24.8), Tech (20.8), Materials (19.5), Consumer Discretionary (17.2), Health Care (16.4), Utilities (0.7), and Real Estate (-11.1) ([Fig. 9](#)).

Strategy II: Giddy Corporate Managers. Last Friday, I was on CNBC's "Halftime Report." I opened by saying, "I'm giddy about this market. The reason I'm giddy about the market is that I've been listening to all these conference calls for the fourth-quarter earnings season, and corporate managements are absolutely giddy with all the cash they are getting" from the TCJA enacted on December 22 of last year. I said, "I think they all went on holiday during Christmas, and they came back in January and opened up their packages, and said, 'Wow, where did we get all this cash from? What are we going to do with it?' On their earnings conference calls, they seemed to be saying, 'Hey, we are going to do everything with it. We are going to buy back shares, pay dividends, pay workers some more.'" One of the panelists asked me what could possibly come after giddy for the market. I said, "more giddy." I should have said, "giddy up!"

I asked Melissa to read the Q4 conference call transcripts for the 30 companies in the DJIA. She confirms that "giddy" is a fair assessment of the general mood of corporate managements. Melissa found lots of examples of giddy language such as: "[T]hat 21% rate looks pretty doggone good," according to executives on the United Technologies earnings call. IBM's top management exclaimed: "So we're delighted, absolutely delighted, that we got tax reform." Here are some more highlights of the giddiness about tax reform:

(1) *Global competitiveness*. Greater global competitiveness for US multinational firms is one of the primary benefits of tax reform, according to top managements of the DJIA companies across several different industries. That view was expressed by the chiefs of 3M, Boeing, Caterpillar, Chevron, Intel, Johnson & Johnson, JPMorgan, Pfizer, Procter & Gamble, Travelers, and Verizon during their earnings calls.

For example: "We believe the US tax reform is positive for Caterpillar over the long term, and then it provides a more competitive environment for us, both domestically and around the world by creating a more level playing field against our non-US competitors," stated the industrial manufacturing company's management. Intel's top management said: "Looking ahead, we expect the Tax Cuts and Jobs Act will help level the playing field for US manufacturers like Intel that compete in today's global economy." Pharma giant Pfizer has been "advocating for many years for comprehensive tax reform. That's because the system that had been in place for US-based multinational companies put them at a competitive disadvantage vis-à-vis foreign competitors with regard to the tax rate and international access to capital. The new tax code addresses these issues and helps level the playing field to make US companies more competitive," said the company's management.

(2) *Capital flexibility*. DJIA companies including Apple, Chevron, Caterpillar, Coke, IBM, Johnson & Johnson, United Technologies, and Verizon also expect greater capital flexibility. They're looking forward to using cash previously parked overseas to deleverage and pay down domestic debt. They're also excited that US investments look more attractive with the lower tax rate. Corporations now also have more capital and the capital flexibility required to pursue those investments.

With respect to deleveraging, Apple's executives said, "What it means to us as a company, of course, is

that we have additional flexibility right now from the access to the foreign cash. And in the past, we've been addressing this issue by having to raise debt as the cash was overseas." The folks at consumer giant Coke stated that tax reform "eliminates a long-standing distortion due to the former US worldwide tax system, which will make it easier for our company to manage its cash and debt balances." J&J's top management said that they'll "no longer need to borrow for US purposes" and will "immediately pay down debt." With tax reform, top management at United Technologies said that the ability to deleverage is "significantly enhanced just with having access to our foreign cash without having to pay a second toll tax on it."

Regarding domestic investment, energy company Chevron's management said, "I think it's good for investment in this country, and we have significant assets here already and opportunities to invest in the future." The folks at chemical giant DowDuPont said that "comprehensive tax reform in the United States" is "a catalyst for increased domestic capital investment." Some of the elements included in the tax reform are provisions that "will allow companies like J&J to have greater flexibility and how we can use overseas earnings to invest for the future, improving the abilities of companies like ours to bring these resources into the US," said the consumer company's top management.

(3) *Domestic demand.* Furthermore, DJIA management teams from Coke, Home Depot, and Procter & Gamble expect a tailwind from increased domestic demand as US consumers benefit from the tax reform. Coke is "well positioned to accelerate top-line performance," buoyed by the "impact of the new US tax legislation on consumer spending," stated the company's top management. Home Depot executives explained that "tax reform is net positive for the housing industry," as consumers will benefit. Procter & Gamble's management team expects it could "disproportionately" benefit from the tax reform to "the extent that disposable income increases" and "plays through into higher consumption."

(4) *Small business investment.* Goldman Sachs executives expect small business investment will grow, which should boost B2B business for the financial titan. On the Goldman Sachs earnings call, the bank's chiefs spoke of "the potential for increased business activity," which "could take many forms including heightened M&A activity, increased financing volumes, or the most important indirect benefit to our business, economic growth."

Strategy III: More Good News Ahead. Melissa adds that many companies are still figuring out how to manage the extra cash from tax reform. That means that there may be more good news to come from companies after it's all sorted out. Executives at Apple said the road may be a bit "bumpy in the short-term as we understand the law in full." The Apple team expects to "provide an update to our specific capital allocation plans when we report results for our second fiscal quarter." Chevron executives noted that "it's probably premature" to get too specific about capital allocation plans. JPMorgan's top management said: "I know that everybody is eagerly awaiting ... direct and noticeable impacts of tax reform, but we're only a couple of weeks into the year."

Though we are waiting for specifics, the commentary from the conference calls points to clear priorities for the uses of cash. First and foremost, organic growth through capital investment is the top priority for most of the DJIA companies. The next priority is to create direct shareholder value via dividends and share repurchase programs. Givebacks to employees through profit-sharing plans and one-time bonuses seem to be on par priority-wise with creating shareholder value. Many companies also noted that they will let the tax reform benefits fall directly to the bottom line.

Interestingly, M&A is at the bottom of the priority list for most of the DJIA companies. Cisco is a notable exception; its management will be looking to make more acquisitions as a result of tax reform. Conversely, most other companies echoed the sentiments of the executives at Visa, who stated that "our priority is to invest in our business organic growth."

Many of the DJIA companies indicated that tax reform doesn't change their capital allocation strategy even as it brings more capital to work with. For example, the JPM team has been "working even before tax reform on identifying where [the] opportunities are" and wants "to lean into that." Merck executives similarly stated: "While tax reform does not fundamentally change our capital allocation priorities, it does improve our flexibility and enhances our ability to deploy capital in support of our strategy." While capital management strategies that predated tax reform will remain in place for many companies, some will be accelerating previously planned investments or funneling extra capital to them. Traveler's top management explained: "[T]here's probably higher earnings and capital to put through that capital management filter, but our thought process around capital management doesn't change."

Regardless of whether capital allocation strategies change as a result of the tax reform, however, the incremental cash expected from tax reform has to go somewhere. Let's discuss where it's most likely to go:

(1) *Capital spending.* By far, business investment is the favorite expected use of capital from the tax reform among DJIA corporations, including 3M, Amex, Boeing, Chevron, Disney, Exxon, Home Depot, J&J, JPMorgan, McDonald's, Pfizer, UnitedHealth, and Walmart. Business investments will range from customer-related initiatives to R&D, exploratory spend, innovation, production and supply-chain systems, and corporate workforce and workplace improvements.

Boeing executives stated: "[T]he tax reform benefit will allow us to accelerate some of [our] work on advance prototyping activities and we'll accelerate work on productivity initiatives and our factory spaces, some of what we call our second century design and manufacturing capabilities, analytics, building out some of [our] vertical capabilities." J&J executives said: "Regarding the more immediate tax reform impact, we think that the wise thing to do is to invest a good portion of that back into R&D." The folks at Home Depot noted that they've elected to pull some people investments forward into fiscal 2018. Walmart executives said: "Tax reform gives us the opportunity to accelerate plans for the US."

(2) *Shareholder value.* Not many companies are clear on how much shareholder value creation will be incremental following the tax reform, but tax reform clearly gives companies additional incentive to continue with dividend plans and share repurchases. During their respective earnings calls, executives at 3M, American Express, Cisco, J&J, McDonald's, P&G, Verizon, and Visa committed to continuing such programs.

For example: "Given the lower tax rate, we expect that over time, we will more than make up for any reductions in the buyback in 2018 and generate more earnings and return more capital than we would have without tax reform," said company management at Amex. "We are going to continue to support the dividend" and give back to the "shareholders through a healthy buyback," Cisco executives told analysts on the call. The P&G management team said that they're increasing their share repurchase plans for fiscal 2018, partly reflecting "the cash benefit enabled by the tax act."

Visa's board increased its quarterly cash dividend in light of tax reform, and Visa executives anticipate continuing to buy back stock during 2018. Walmart is similarly focused on increasing shareholder value, with execs saying: "We also remain committed to our dividend, as evidenced by the increase we announced today" and the share repurchase program announced back in October.

(3) *Employee benefits.* Owing to the tax reform, 3M, Amex, Home Depot, Pfizer, Visa, and Walmart announced incremental contributions to either pension or employee profit-sharing plans or to bonuses. Only Walmart said anything about increasing wages, although it might have done that with or without the tax reform. Since one-time retirement plan contributions and bonuses don't change consumers'

longer-term spending patterns, these uses of capital will probably not provide much ongoing support to the US economy or the markets. But it's reasonable to speculate that higher wages will follow better profitability once the capital investments noted above get under way.

CALENDARS

US. 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. **Thurs:** Personal Income & Consumption 0.3%/0.2%, Headline & Core PCED 1.7%/1.5% y/y, Total & Domestic Motor Vehicle Sales 17.1mu/13.0mu, Construction Spending 0.3%, Jobless Claims 230k, ISM & Markit M-PMIs 58.6/55.7, Weekly Consumer Comfort Index, EIA Natural Gas Report, Powell, Dudley. (*Wall Street Journal* estimates)

Global. Wed: Eurozone CPI Flash Estimate 1.2% y/y, 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. **Thurs:** Eurozone Unemployment Rate 8.6%, Eurozone, Germany, France, and Italy M-PMIs 58.5/60.3/na/58.0, Italy GDP 1.7% y/y, UK M-PMI 55.0, Japan Consumer Confidence 44.8, Japan Jobless Rate 2.8%, Japan Household Spending -0.4% y/y, Japan M-PMI, China Caixin M-PMI 51.3. (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—reached a new record high during the week of February 17, after a brief pullback the previous week. It has climbed five of the past six weeks by a total of 8.7%. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). Our BBB jumped 13.8% over the six-week period, fractionally below its record high posted in early February; jobless claims, one of the components of our BBB, declined five of the last six weeks—from 250,750 to 226,000 (4-wa)—back near its 45-year low of 225,000 posted in early February. Meanwhile, the CRB raw industrial spot price index, another BBB component, is rebounding from its recent setback. The WCCI remains on a steep uptrend, reaching new cyclical highs.

US ECONOMIC INDICATORS

Consumer Confidence ([link](#)): Consumers haven't been this optimistic since 2000! Consumer confidence has been rising in the early months of 2018, climbing from 123.1 in December to 130.8 this month—the highest level since November 2000. According to the Conference Board's Lynn Franco, "Overall, consumers remain quite confident that the economy will continue expanding at a strong pace in the months ahead." Consumers are enthusiastic about both the present and future. The present situation component jumped to 162.4 this month—the highest since March 2001, while the expectations component has rebounded from 100.8 to 109.7 the past two months, heading back toward last March's cyclical high of 112.3. The current job outlook is the best since 2001: Jobs plentiful jumped to 39.4% this month, the highest percentage since April 2001, while jobs hard to get sank to 14.7%, the lowest since July 2001. The six-month jobs' outlook showed the percentage expecting more jobs (21.6%) continued to surpass those expecting fewer jobs (11.9), with the spread widening from 3.0ppts in December to 9.7ppts this month, approaching March 2017's cyclical peak of 11.1%.

Durable Goods Orders & Shipments ([link](#)): Both core capital goods shipments and orders in January remained at high levels, though the latter posted its first back-to-back decline since early 2016.

Nondefense capital goods orders ex aircraft (a proxy for future business investment) edged down 0.2% last month after a 0.6% decline in December, while the comparable shipments measure (used in calculating GDP) climbed for the 12th straight month—up 0.1% m/m and 8.8% y/y—though its growth has slowed in recent months. Core capital goods orders expanded 3.6% (saar) during the three months through January, based on the three-month average, slowing from double-digit gains the prior four months; the comparable shipments measured grew 8.0% (saar), slowing steadily from its recent peak of 14.1% recorded in the three months through October. Headline durable goods orders sank 3.7%, driven by an expected plunge in volatile commercial jet orders (-28.4%). Excluding transportation, orders fell for the first time in nine months, by 0.3%, following a surge of 5.6% the last six months of 2017 to its highest level since June 2008.

Regional M-PMIs ([link](#)): Five Fed districts have now reported on manufacturing activity for this month—New York, Philadelphia, Kansas City, Dallas, and Richmond—and they show growth in the sector is the fastest since July 2004. We average the composite, orders, and employment measures as data become available. The composite index accelerated from 20.7 to 24.2 this month, driven by the best growth in the Dallas (to 37.2 from 33.4) region since the end of 2004 and a significant pickup in the Richmond (28 from 14) region. 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 (21.3 from 15.5) improved, led by an acceleration in the Richmond (27 from 16) and Philly (24.5 from 10.1) regions; 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 12.8 to 20.6 this month—a high for this series going back to June 2004. Manufacturers in all five regions—Philly (25.2 from 16.9), Richmond (25 from 10), 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, with Richmond's at a new record high.

GLOBAL ECONOMIC INDICATORS

Eurozone Economic Sentiment Indicators ([link](#)): February's Economic Sentiment Indexes (ESI) for the Eurozone (-0.8 points to 114.1) and the EU (-0.5 points to 114.3) both eased for the second month from December's 17-year highs. This month, ESIs for only two of the five largest Eurozone economies improved—Italy (+1.5 to 111.6) and the Netherlands (+0.4 to 113.3), with the latter at a new cyclical high. France's (-2.7 to 109.7) ESI dropped markedly for the second month since reaching a cyclical high of 113.9 in December, while Germany's (-1.6 to 114.4) eased from January's cyclical high and Spain's (-0.7 to 110.2) held around its cyclical high. At the sector level, only services (+0.7 to 17.5) confidence was in the plus column; consumer (-1.3 to 0.1), industry (-1.0 to 8.0), retail trade (-0.9 to 4.3), and construction (-0.5 to 4.2) confidence all lost ground this month, though remained at relatively high levels.

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