



MORNING BRIEFING

March 6, 2018

Known Knowns & Unknowns

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

(1) Tight labor market in US. (2) Global Growth Barometer trending higher. (3) Exports are booming and so are imports, resulting in wider trade deficit. (4) Global export indicators are booming. (5) Revenues per share of All Country World MSCI is at a record high. (6) Analysts now expect TCJA to add almost \$12 per share to S&P 500 earnings this year. (7) Protectionism may or may not be a problem. (8) Inflation may or may not remain subdued. (9) The Bond Vigilantes may or may not saddle up.

Strategy I: What Do We Know? We know that the fundamentals driving earnings are very strong. We know that the US economy is performing well. The US labor market is essentially at full employment, with initial unemployment claims falling to 210,000 last week, the lowest since December 1969 ([Fig. 1](#)). We know that the number of job openings is equal to the number of unemployed workers, suggesting that most of the unemployment can be described as “frictional,” resulting from geographic and skills mismatches ([Fig. 2](#)).

We know that the global economy is experiencing widespread synchronized growth. Our Global Growth Barometer, which is simply an average of the CRB raw industrials spot price index and the price of a barrel of Brent crude oil, remains on an uptrend that started in early 2016 ([Fig. 3](#)). Eurozone retail sales (excluding motor vehicles) is also on an uptrend, and in record-high territory ([Fig. 4](#)).

Most impressive are all the global export statistics suggesting that the economies around the world are benefitting mightily from a global exports boom. Consider the following:

(1) *United States*. Debbie and I are impressed by the strength in the volume of US exports during December ([Fig. 5](#)). It rose 6.1% y/y to a record high of \$1,578 billion (saar). The problem is that the volume of imports rose 7.2% y/y to a record high of \$2,399 billion, causing the monthly inflation-adjusted trade deficit to widen to \$821 billion, the widest gap since March 2007.

Debbie and I have found that the sum of US real exports and real imports is a very good proxy for the volume of global exports ([Fig. 6](#) and [Fig. 7](#)). Both rose to new record highs during December, with y/y gains of 6.8% and 4.5% respectively.

Another useful indicator of global trade is the sum of the US M-PMI's new exports order and imports components ([Fig. 8](#)). It soared from 118.2 during January to 123.3 during February, the highest reading on record. This index is highly correlated with the y/y growth in the volume of global exports.

(2) *G6 economies*. The sum of the exports of the G6 economies (i.e., the G7 excluding the US) is up 17.5% from December 2015 through December 2017 ([Fig. 9](#) and [Fig. 10](#)).

(3) *Global revenues*. We know that the widespread strength in global economic activity, as evidenced by the latest trade data, is boosting the revenues per share of the All Country World MSCI stock price index ([Fig. 11](#)). Industry analysts are expecting revenues (in local currencies) to rise 5.9% this year and 4.5% next year, pushing forward revenues per share to a record high. The latter has been recovering since early 2016 from the global energy-led mini-recession during 2015.

Similarly, S&P 500 revenues per share is expected to increase 6.4% this year and 6.9% next year ([Fig. 12](#)). The estimates for 2018 and 2019 have increased by 2.9% and 2.6%, respectively, since the first week of September. We believe these upward revisions have had more to do with the pickup in global economic growth than any spillover effect from the Tax Cut and Jobs Act (TCJA) passed late last year in the US.

(4) *US earnings*. We also know that S&P 500 earnings will get a huge boost from the TCJA this year. During the 11 weeks since the TCJA was enacted through the week ended March 1, industry analysts have raised their 2018 consensus estimate by \$11.72 per share from \$146.26 to \$157.98 currently ([Fig. 13](#)). So they are forecasting a 19.0% increase this year. Next year, they are projecting another double-digit gain of 10.0%.

Strategy II: What Don't We Know? So we know what we know. On balance, the list of what we know is fundamentally bullish for stocks. We also have a list of known unknowns that might be bearish for stocks. Here are the items at the top of this list:

(1) *Protectionism*. Jumping from near the bottom of the list to the top of the list since late last week is a trade war. President Donald Trump signaled during January that the passage of his tax reform plan now allows him to move to the protectionist plank of his campaign platform. He did so by slapping tariffs on imports of solar panels and washing machines during the first month of the year. Last Thursday, he stated that he aims to do the same on imports of aluminum and steel. Since then, he has bobbed and weaved around the subject, which suggests that he might be posturing to get a better deal out of the current process of renegotiating NAFTA with Mexico and Canada.

I continue to believe that Trump won't end globalization by triggering a worldwide trade war. Rather, I think he will do what he can to convert multilateral trade deals into bilateral ones that can more easily be adjusted as circumstances change. However, I know this is a known unknown because the President is hard to predict.

(2) *Inflation*. Reflationists are making a good case for reflation. They note that the US labor market is very tight and wage inflation may have started to pick up in January finally. They observe that commodity prices have been trending higher. Fiscal policy has turned more stimulative as a result of the TCJA and the recent deal by congressional Republicans and Democrats to keep the government open by spending more money! If Trump proceeds with raising more tariffs, that will drive up prices of import and import substitutes in the US.

On the other hand, inflation remains subdued. The PCED inflation rate was 1.7% y/y during January, while the core rate was even lower at only 1.5% ([Fig. 14](#)). Fed officials are still expecting the core rate to rise to their 2% target this year. Debbie and I continue to believe that the powerful secular forces of competition attributable to globalization, technological innovation, and aging demographics will keep a lid on inflation.

(3) *Interest rates*. We know that the Fed is on a course of gradually raising the federal funds rate at the same time that it is reducing its balance-sheet portfolio of US Treasuries and mortgage-backed securities. We don't know how the bond market will respond to the Fed's policy normalization. If inflation does make a comeback, then the bearish reaction in the bond market would be more severe than otherwise. If protectionism prevails, bond yields might move higher if foreigners retaliate by selling their US bonds. Or, yields might go lower if protectionism depresses global economic activity.

For now, we are putting much more weight on the known knowns that are bullish for stocks than on the bearish known unknowns. As for the unknown unknowns, we don't know.

CALENDARS

US. Tues: Factory Orders -1.2%, Dudley, Brainard. **Wed:** ADP Employment 203k, Merchandise Trade Balance -\$55.1b, Productivity & Unit Labor Costs -0.1%/2.2%, Consumer Credit \$17.8b, MBA Mortgage Applications, EIA Petroleum Status Report, Beige Book, Dudley, Bostic. (*Wall Street Journal* estimates)

Global. Tues: RBA Cash Rate Target 1.5%, Lowe. **Wed:** Eurozone GDP 0.6%q/q/2.7%y/y, Japan GDP 0.2%q/q/0.0%y/y, Japan Leading & Coincident Indexes 106.1/115.3, Australia GDP 0.5%q/q/2.5%y/y, BOC Rate Decision 1.25%. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings rose to record highs last week for all three indexes, but the pace slowed substantially as the Q4 earnings season entered the final stretch. LargeCap's forward earnings was higher for a 32nd straight week; MidCap's was higher for a 28th week; and SmallCap's has risen in 26 of the past 32 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 20.1% y/y from 19.9%, which is its highest since May 2011 and compares to a six-year low of -1.8% in October 2015; MidCap's dropped to 23.4% from 23.9%, which had been the highest since April 2011 and compares to a six-year low of -1.3% in December 2015; and SmallCap's jumped to 22.1% from 20.3%, which was the highest since August 2011 and compares to a six-year low of 0.3% in December 2015. MidCap's consensus expected earnings for 2018 edged down w/w, as LargeCap and SmallCap improved at the slowest rate since the passage of the TCJA. Here are the latest consensus earnings growth rates for 2018 and 2019: LargeCap 19.0% and 10.0%, MidCap 20.4% and 11.9%, and SmallCap 23.6% and 15.4%.

S&P 500/400/600 Forward Valuation ([link](#)): Last week saw forward P/E ratios take a hit for all three indexes, but they remained above their February 8 lows. LargeCap's weekly forward P/E fell to 16.7 from 17.1, but remains above its 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 dropped to 16.7 from 17.0, but is up from the panic attack's 23-month low of 16.2. MidCap's P/E has been at or below LargeCap's P/E since August for the first time since 2009. It's 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 was down w/w to 18.0 from 18.3, 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 2.03 is down from a record high of 2.19 on January 26, MidCap's 1.34 remains below its record high of 1.40 then, and SmallCap's 1.03 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 nearly complete, revision activity for the Q1-2018 earnings forecasts has slowed as well. The S&P 500's Q1-2018 EPS forecast was unchanged w/w at \$36.24. 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%, unchanged from a week earlier, and compares to Q4-2017's blended 15.2%, 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 21.1%, followed by the forecasts for Telecom (up 14.4%), Financials (11.8), and Utilities (5.6). Real Estate's Q1-2018 forecast is down 5.1%, followed by small gains for Consumer Staples (0.6), Materials (0.7), Tech (1.9), Consumer Discretionary (4.2), Industrials (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—with eight rising at a double-digit percentage rate—and four are expected to beat the S&P 500's forecasted y/y earnings gain of 18.2%. That's better than the 10 sectors rising y/y during Q4-2017, when seven rose at a double-digit pace or better. Analysts expect Energy to report another large profit jump in Q1 relative to very low earnings a year ago, but the pace will slow from triple digits in Q4. 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 (75.1% in Q1-2018 vs 123.6% in Q4-2017), Materials (27.5, 35.9), Financials (24.2, 13.5), Tech (22.3, 20.1), S&P 500 (18.2, 15.2), Industrials (14.2, 7.4), Telecom (13.3, 4.9), Health Care (10.4, 8.5), Utilities (10.2, 13.1), Consumer Staples (9.8, 11.9), Consumer Discretionary (9.2, 10.6), and Real Estate (3.4, -2.4). On an ex-Energy basis, S&P 500 earnings are expected to rise 16.3% y/y in Q1, up from a blended 13.0% in Q4 and 6.1% in Q3 (which was the slowest growth since ex-Energy earnings rose just 2.2% in Q2-2016).

GLOBAL ECONOMIC INDICATORS

Global Composite PMIs ([link](#)): Global economic activity in February reached a 3.5-year high as stronger growth in the service sector more than offset slightly weaker growth in the manufacturing sector. The JP Morgan Global Composite Output Index (C-PMI) climbed for the fifth straight month, from 53.8 in September to 54.8 in February—its best reading since September 2014. The NM-PMI (54.8 from 54.1) rose to its best pace since March 2015, while the M-PMI (to 54.2 from 54.4) was little changed for the second month from December's near-seven-year high of 54.5, with both measures expanding at similar paces. C-PMIs show developed markets (55.4 from 54.9) continued to outperform emerging markets (53.3 from 53.6), though the latter has been playing catch-up in recent months. The Eurozone C-PMI (57.1) eased a bit from January's near-12-year high of 58.8, but remained a bright spot, according to the latest report. Growth slowed in Germany (57.6), France (57.3), Ireland (56.8), and Italy (56.0), though all remained at elevated levels, while Spain's (57.1) reached an eight-month high. The US C-PMI (55.8 from 53.8) saw a marked acceleration in growth last month; rates also improved in the UK (54.5 from 53.4), Russia (55.2 from 54.8), and Brazil (53.1 from 50.7), while growth slowed in China (53.3 from 53.7) and Japan (52.2 from 52.8).

Global Non-Manufacturing PMIs ([link](#)): The global service-sector gathered further momentum in February, accelerating at its best pace since March 2015. JP Morgan's NM-PMI recovered for the third month from 53.7 in November to nearly a three-year high of 54.8 in February. Last month, the Eurozone NM-PMI (to 56.2 from 58.0) hit a speed bump, slipping a bit from January's 10.5-year high, with solid growth continuing in the major economies of France (57.4), Spain (57.3), Ireland (57.2), Germany (55.3), and Italy (55.0); Spain's was the only one that saw an acceleration in activity. Meanwhile, the US (55.9) service sector expanded at the second-best reading in over two years, while NM-PMIs in the UK (54.5) and Russia (56.5) were the highest in four and two months, respectively, while Brazil's (52.7) expanded at a five-year high after contracting for five of the last six months of 2017. Growth slowed only slightly in China (54.2 from 54.7) and Japan (51.7 from 51.9).

US Non-Manufacturing PMI ([link](#)): The US service sector in February grew at a robust pace according

to both NM-PMI measures. ISM's NM-PMI (59.5 from 59.9) barely budged from January's pace, which was the fastest since August 2005. Two of the four components accelerated sharply last month, with the new orders (to 64.8 from 62.7) gauge soaring to a 12.5-year high and the business activity (62.8 from 59.8) measure to a one-year high. Meanwhile, the employment (55.0 from 61.6) gauge fell to a seven-month low, after jumping above 60.0 in January for the first time since 2005; suppliers' deliveries was unchanged at 55.5 again last month. Markit's NM-PMI jumped to a six-month high of 55.9 last month, after sliding the prior three months from 55.3 to 53.3. Output accelerated at its best rate since August 2017, while greater client demand led to the steepest rise in new business in almost three years, enabling businesses to boost employment.

Eurozone Retail Sales ([link](#)): Retail sales in January retreated for the second month, though remained near November's record high. Sales fell 0.1% in January and 1.0% in December, following a 2.0% rebound in November. Sales of non-food products and food, drinks & tobacco fell 1.7% and 0.6%, respectively, over the two months through January, while automotive fuel sales ticked up 0.1% after falling 0.5% in December. Sales are available for only two of the Big Four economies, and show a mixed picture, with France's (0.6%) expanding and Germany's (-0.7) contracting. The biggest sales declines in January were posted in Estonia (-2.4%), Belgium (-1.6), and Malta (-1.4), while the biggest gains occurred in Finland (1.3) and Austria (0.7).

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