



MORNING BRIEFING

April 5, 2018

Margin Pressures

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

(1) Is the market-cap weight of the Tech sector too high? (2) Tech earnings justify high market-cap share, but not if the sector's profit margins are at risk. (3) Why is Walmart eyeing Humana? (4) While overall inflation remains subdued, there are a few signs of mounting inflationary pressures. (5) Striking teachers and shortage of truck-driving Teamsters. (6) USTR report says China doesn't play fair.

Technology: Weighting Game. During the tech wreck of the past week, analysts frequently warned that the S&P 500 Tech sector made up 24.7% of the S&P 500's market capitalization. That factoid is indeed true. It's also true that the sector's market capitalization hasn't been this high since the 2000 tech bubble, and we all know how that ended.

However, we can counter that the Tech sector's unarguably large market-cap contribution is deserved because Tech delivers far more earnings than do other S&P 500 sectors. Let's dive into the data:

(1) *Outstanding share of S&P 500 earnings.* The S&P 500 Tech sector kicks in 23.1% of the S&P 500's earnings, only slightly less than its 24.7% market capitalization share. From roughly 2011 through 2017, the Tech sector's capitalization share was less than its earnings share. Only in the past year has its capitalization share eclipsed its earnings share. However, in most periods from 1995 through 2010, Technology's capitalization share was more than or equal to its earnings share ([Fig. 1](#) and [Fig. 2](#)).

The Tech sector also contributes more earnings to the S&P 500's total than any other sector. Here's a performance derby of the S&P 500 sectors' market capitalization and their forward earnings share at the end of March, based on weekly data: Tech (24.7%, 23.1%), Financials (14.8, 18.8), Health Care (13.8, 14.9), Consumer Discretionary (12.6, 10.6), Industrials (10.2, 10.0), Consumer Staples (7.7, 7.3), Energy (5.7, 5.0), Utilities (2.9, 2.9), Materials (2.8, 3.0), Real Estate (2.8, 1.2), and Telecom Services (2.0, 3.0) ([Fig. 3](#)).

(2) *Moderate revenue.* The bears have a stronger case if they turn to the percentage of revenue that Tech kicks in as a member of the S&P 500. Tech contributes 12.4% of the S&P 500's total revenue, less than two other sectors do and about the same as two others: Health Care (16.1%), Consumer Discretionary (15.8), Tech (12.4), Consumer Staples (12.4), Financials (12.3), Industrials (11.9), Energy (9.5), Materials (3.1), Utilities (2.9), Telecom Services (2.7), and Real Estate (0.9) ([Fig. 4](#)).

(3) *Magnificent margins.* In order for Tech to produce a sensational earnings contribution out of just a middling revenue contribution, the sector needs to maintain its above-average operating profit margin of an estimated 22.3%, which is the consensus expectation based on forward earnings estimates. That margin is almost twice the operating margin for the S&P 500, 12.0%. Therein lies the risk: If the government clamps down and begins regulating the industry, the Tech sector may no longer be as profitable as it has been in the past.

Here are the estimated forward operating profit margins for the S&P 500 sectors: Tech (22.3%), Financials (18.3), Real Estate (16.2), Telecom Services (13.2), Utilities (12.1), Materials (11.4), Health Care (11.1), Industrials (10.1), Consumer Discretionary (8.1), Consumer Staples (7.1), and Energy (6.3) ([Fig. 5](#)).

Retailers: Desperately Seeking Margin. Retailing—especially in the time of Amazon—is a margin-crushing experience. The S&P 500 Hypermarkets & Super Centers stock price index is expected to have an operating profit margin of only 2.6% this year, and that’s up a touch from last year’s ([Fig. 6](#)).

Walmart and Costco both are members of this industry, and they sell millions of items so that the pennies they make on most items ultimately add up to a profitable business. Earnings in the industry are expected to grow 13.9% in 2018 (helped by tax cuts) and 7.7% in 2019 ([Fig. 7](#)).

So perhaps it shouldn’t be a surprise that Walmart might be interested in jumping into the health care industry by buying Humana. The health care insurer is a member of the S&P 500 Managed Health Care stock price index, which analysts forecast will have earnings growth of 22.5% this year and 12.6% growth next year ([Fig. 8](#)). The industry has operating margins moderately better than the retailers’, an estimated 4.8% in 2018 ([Fig. 9](#)).

While combining the two companies might help Walmart’s bottom line if the deal happens at the right price, it won’t solve the company’s Amazon problem. We’ve long held that Amazon’s success is bolstered by its Amazon Web Services business, which has wide margins and fast growth. With operating margins of 24.8% and 39.4% operating income growth last year, the web services division looks much better than Amazon’s North American operations, which had a 2.7% operating margin and operating income growth of 20.2%, and its International operations, which had an operating loss. Entering the health care business won’t solve that problem for Walmart.

Inflation: On the Lookout. While wage inflation remains subdued, we remain ever vigilant for anecdotal signs that it could start percolating, especially with the unemployment rate at 17-year low of 4.1% ([Fig. 10](#)). In recent days, a number of stories have described employee efforts to fatten their paychecks and employers’ struggle to find employees for open positions ([Fig. 11](#)). Jackie is on the lookout for inflation and reports the following developments:

(1) *Teachers striking.* Teachers in Oklahoma, West Virginia, and Kentucky, have walked out or held strikes in recent weeks to improve their pay and/or get increased funding for schools.

At least 50 school districts in Oklahoma were shut Monday and Tuesday as teachers protested budget cuts and demanded higher wages, a 4/3 *NYT* [article](#) reported. Teachers also went to Oklahoma City to lobby lawmakers to pass a tax package to raise another \$200 million for the state school budget.

“In Oklahoma, teachers asked for a \$10,000 raise for themselves, a \$5,000 raise for support staff, \$200 million over three years in funding for local schools and \$500 million over three years in funding for state agencies and other public employees. After Gov. Mary Fallin signed legislation last week that would increase teachers’ base salaries by an average of \$6,000 and provide \$18 million in operations funding for schools, the Oklahoma Education Association, the state’s largest teachers’ union, said a bill without full funding wasn’t enough.”

Kentucky teachers also held walkouts Monday, but most returned to classrooms or their scheduled holiday breaks on Tuesday. They too have gone to their state capitol to object to budget cuts and a bill that would make their pensions more like 401(k) retirement accounts.

Teachers in Arizona have threatened job actions, and organizers are looking to build support in rural areas for a walkout. Teachers are asking for a 20% raise and an increase in school funding.

Many of the walkouts were inspired by the nine-day teacher strike in West Virginia. The strike ended last month with the teachers and other state employees receiving a 5% pay raise. In addition, a task force was created to find a funding solution for the Public Employees Insurance Agency.

(2) *Midwest needs employees.* Here's an amazing statistic: In the Midwest, there are more unfilled positions than there are unemployed people, according to a 4/1 *WSJ* [article](#). Employers are scrounging for employees to fill job openings as a result.

The article used Stellar Industries, a commercial truck manufacturer, as an example. The company has its biggest backlog of orders ever, yet it "has an assembly line sitting unused because [the company] can't find the workers to staff a second shift. Normally, [the] 450-employee company fills orders in about eight weeks. Today, it takes 18 weeks or more."

Part of the problem was attributed to the net 1.3 million people living in the Midwest in 2010 who had left by the middle of last year. And fewer immigrants moving to the Midwest doesn't help the labor market.

Here's a [list](#) of states with the lowest seasonally adjusted unemployment rates for February: Hawaii (2.1%), New Hampshire (2.6), North Dakota (2.6), Nebraska (2.8), Vermont (2.8), Iowa (2.9), Maine (2.9), Wisconsin (2.9), Colorado (3.0), and Idaho (3.0).

(3) *Trucks need drivers.* The need for truck drivers hasn't let up since we detailed the shortage in the past. Here, too, the statistics are eye-opening.

"Transportation research firm FTR estimates carriers overall will add 50,000 drivers in 2018. But the industry will need to add between 150,000 and 200,000 drivers over the next year and a half to replace people leaving trucking and to meet new demand," a 4/3 *WSJ* [article](#) reported.

Again, the dearth of labor is having a ripple effect on the economy as companies can't get their cargo moved on time or at a reasonable cost. The article explained: "General Mills ... said during an earnings call in March that freight costs on the spot market for truck transportation were near a 20-year high, joining a growing lineup of retailers and manufacturers that have pointed to higher costs and lost business from transportation constraints."

A wage increase hasn't even helped attract enough truckers. "The American Trucking Associations, a trade group that represents fleet owners, said annual truck-driver salaries rose between 15% and 18% from 2013 to 2017, with growth varying based on the type of fleet and the nature of the routes," a 3/28 *WSJ* [article](#) reported. "Some private-fleet drivers earned as much as \$86,000 annually in 2017, up from \$73,000 in the group's 2013 survey, on top of benefits packages that included new paid leave offers and more-generous retirement plans. The survey showed the median salary for a truckload driver working a national, irregular route—essentially an entry-level driving position—was \$53,000, up \$7,000 or 15% from 2013."

(4) *More visas, please.* A record number of summer H-2B visas were requested on the first day possible to file for them. "For this summer season, businesses filed requests for more than 81,000 workers with the Labor Department on Jan. 1, the first day possible, a record, and more since then. Many firms tried to file applications after midnight on New Year's Eve to be near the front of the line," a 3/30 *WSJ* [article](#) reported.

The annual visa cap is 66,000, evenly divided between winter and summer help. There have been failed attempts in Congress to lift the cap, so now businesses are pressuring the Department of Homeland Security to authorize extra visas. However, last year the Trump White House pressured the department not to raise the cap, because the President campaigned on the idea of protecting American workers against foreign competition. The department, then headed by current White House Chief of Staff John Kelly, decided to allow an extra 15,000 visas.

China Trade: SOEs, SFPEs, and OFDI. Last week, Melissa and I covered a few of the key points within the USTR's Section 301 [report](#) (see our [3/26](#), [3/27](#), and [3/29 Morning Briefings](#)). We discussed China's overt strategic plans for global technology dominance through its IDAR approach: introduce, digest, assimilate, and re-innovate. The USTR paints the approach as a means for China to steal intellectual property from abroad, asserting that the Chinese government does so by crafting unfair policies. These policies create an uneven playing field for foreign entities that must choose to comply or forgo access to some of the largest markets in the world.

In our final instalment of this series, we discuss one of the eye-opening conclusions of the USTR's report: China's increasing outbound foreign direct investment (OFDI), primarily in technology, is not motivated by profits as much as by the interests of the state. China often conducts OFDI through investments sourced from state-owned enterprise (SOE), obviously controlled by the state. Less conspicuously, the state also exerts its influence and control over private entities. Melissa and I think that an appropriate acronym for these would be "SFPEs," for "state-funded private enterprises." Consider the following points lifted from the USTR's report:

(1) *OFDI.* Chinese investment in the US has grown rapidly, as the three primary sources of China's OFDI data show. The Bureau of Economic (BEA) analysis estimates that flows of Chinese outbound foreign direct investment into the US rose by 835%, from \$1.1 billion in 2011 to \$10.3 billion, in 2016. The China Global Investment Tracker and the China Investment Monitor use a different approach than the BEA to collect data, but they show a similar "increasing trend." The increase in OFDI varies from sector to sector. However, investment has "generally risen significantly across" each of the major technology sectors. (For visual support, see the charts on pages 99 and 101 of the USTR's report.)

(2) *FDI Catalogue.* OFDI in technology rapidly has increased at the same time as the state has the outlined strategic objective of technology dominance. In a 2017 report, the US Chamber of Commerce observed that "the [Chinese] state appears to be supporting acquisition strategies of Chinese state-owned and state-supported companies tied to [Made in China 2025] priority sectors." We discussed Made in China 2025 and other policies supporting China's goal to become a global technology leader in our [3/27 Morning Briefing](#). We also previously discussed (in our [3/29 Morning Briefing](#)) the outbound investment approvals system, which is guided by the Foreign Investment Catalogue (FDI Catalogue). The FDI Catalogue rates the government's stance on sectors from "encouraged" to "restricted." Importantly, the ratings apply to all enterprises, not just SOEs.

The USTR report observes: "Investments that are 'encouraged' receive several forms of government support, including: subsidies for fees incurred, and bank loans at government-subsidized interest rates; policy bank loan support; priority administrative approval; priority support for the use of foreign exchange; export tax rebates on exports of equipment and other materials relating to the overseas investment project; priority access to services relating to overseas financing, investment consultation, risk evaluation, risk control, and investment insurance; and coordinated support from several government departments with respect to information exchange, diplomatic protections, the travel of personnel abroad, and registration of import and export rights."

(3) *SFPEs*. Obviously, the state exerts a high level of influence and control over SOEs. China's SOEs "account for a significant share of overall outbound investment, and are responsible for many of the largest overseas transactions," notes the USTR report. One source stated that much "Chinese FDI comes from state-owned enterprises that often have different motives than simply maximizing profits. Rather, their investments often serve strategic state goals."

Less conspicuously, private Chinese entities involved in OFDI increasingly are funded by the government or have indirect linkages to the state. Private enterprises "often rely on capital from state-owned policy banks, state-owned commercial banks, or state-backed funds to make an investment project viable." Further, Chinese Communist Party (CCP) committees now exist in 70% of 1.86 million privately owned companies. (Starting on page 103 of the USTR report, specific examples are given of government linkages to OFDI.)

(4) *MCF*. Controversial as it may be, the Trump administration's recent imposition of tariffs on China on the grounds of national security may be justified. After all, China hasn't hidden that its interest in technological innovation is motivated in part by its militarization goals. Military Civil Fusion (MCF) was elevated as a national strategy by General Secretary Xi Jinping in 2014. MCF "embodies China's national strategic philosophy of coordinating the planning of economic development and national security (i.e. military-defense) to fully realize the rejuvenation of the Chinese nation," states the USTR report. "MCF emphasizes indigenous development, restriction of inbound FDI, and the absorption of foreign technologies and know-how in key sectors."

CALENDARS

US. Thurs: Merchandise Trade Balance -\$56.7b, Jobless Claims 229k, Weekly Consumer Comfort Index, Challenger Job-Cut Report, EIA Natural Gas Report, Bostic. **Fri:** Total, Private, and Manufacturing Nonfarm Payroll Employment 175k/175k/20k, Unemployment & Participation Rates 4.0%/62.8%, Average Hourly Earnings 0.3%/m/m/2.7%/y/y, Average Workweek 34.5hrs, Consumer Credit \$15.1b, Baker-Hughes Rig Count, Powell. (*Wall Street Journal* estimates)

Global. Thurs: Eurozone Retail Sales 0.6%/m/m/2.3%/y/y, Germany Factory Orders 1.5%/m/m/6.3%/y/y, Eurozone, Germany, France, and Italy Composite PMIs 55.3/55.4/56.2/54.9, Eurozone, Germany, France, and Italy NM-PMIs 55.0/54.2/56.8/53.9, UK Composite & NM-PMIs 53.9/54.0. **Fri:** Germany Industrial Production 0.2%/m/m/4.3%/y/y, Canada Employment Change & Unemployment Rate 20k/5.8%, Japan Leading & Coincident Indicators 105.5/116.1. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators ([link](#)): Our Bull/Bear Ratio (BBR) fell further below 3.00 this week. The BBR sank for the third week from 3.50 to 2.63 over the period; 11 weeks ago, it was at 5.25—which was the highest reading since early April 1986. Bullish sentiment dropped for the second week to 47.6%, after rising the prior three weeks from 48.1% to 55.5%, with nearly all fleeing to the correction camp. The correction count jumped for the second week to 34.3% this week after falling from 37.5% to 27.7% the prior three weeks. Bearish sentiment climbed for the fifth week from 14.4% to 18.0% over the period, after little change the prior few weeks. The AAI Ratio declined for the second week last week from 63.3% to 47.5% over the period. Bullish sentiment fell from 36.8% to 31.9% over the two-week span, while bearish sentiment rose from 21.3% to 35.3%.

S&P 500 Earnings, Revenues & Valuation ([link](#)): Last week saw S&P 500 consensus forward revenues rise back to a record high for the first time in four weeks, and forward earnings recovered from its first decrease in 35 weeks to rise to a new record high. The 2018 and forward profit margin

forecasts were steady w/w at 11.8% and 12.0%, respectively, but the 2019 profit margin edged down 0.1ppt to 12.4%. Prior to the passage of the TCJA, the forward profit margin had been steady at 11.1% since October, which was the highest since September 2015 and up from a 24-month low of 10.4% in March 2016. Forward revenue growth for the S&P 500 was steady w/w at 6.1%, which is little changed from an 80-month high of 6.3% at the end of February. That reading compares to a cyclical low of 2.7% in February 2016. Forward earnings growth of 16.3% was also steady w/w, but that's down from 16.9% in late February, which had been the highest since October 2010. Still, that's up 5.2ppts from 11.1% prior to the passage of the TCJA, and 11.5ppts from the cyclical low of 4.8% in February 2016. Among the 11 sectors, forward earnings growth forecast improved for four, by amounts between 0.1-0.3ppt, and weakened for three, by between 0.1-0.4ppt. Energy's contribution to forward growth peaked at the start of 2017. Looking at last week's results, the S&P 500 ex-Energy's forward growth improved by 0.1ppt to 5.6% for revenues and held steady at 15.0% for earnings. The S&P 500 ex-Energy forward profit margin remained steady at a record high of 12.6%, which is up from 11.7% before the TCJA. The S&P 500's forward P/E dropped to 16.3 from 17.0, which compares to a 16-year high of 18.6 at the market's peak in late January and a 15-month low of 14.9 in January 2016. The S&P 500 price-to-sales ratio fell to 1.95 from 2.04, which compares to late January's record high of 2.16.

S&P 500 Sectors Earnings, Revenues & Valuation ([link](#)): Consensus forward revenues forecasts rose last week for 6/11 sectors, but forward earnings rose for 8/11. These five sectors saw both measures rise: Consumer Staples, Financials, Materials, Tech, and Utilities. For Real Estate and Telecom, both measures weakened. Forward revenues and earnings are at or around record highs for 5/11 sectors: Consumer Discretionary, Consumer Staples, Health Care, Industrials, and Tech. Energy's forward revenues and earnings appear to be back on uptrends after stalling during 2016-2017, and earnings have about tripled from their 18-year low in April 2016. Forward P/S and P/E ratios are down from their highs for all sectors. Energy's valuations remain elevated relative to historical levels, but are normalizing now after soaring in 2016 when revenues and earnings collapsed. Energy's P/S ratio of 1.17 compares to a record high of 1.56 in May 2016, and its P/E of 18.7 is down from a record high of 57.5 then. Due to the TCJA, higher margins are expected y/y in 2018 for all sectors but Real Estate, but that sector's earnings includes gains from property sales and typically improves as the year progresses. The post-TCJA improvements in forward profit margins are waning now: Energy's rose 0.1ppt w/w for the sole gain among the 11 sectors, and two sectors' forward margins edged down 0.1ppt (Real Estate and Tech). Here's how the sectors rank based on their current forward profit margin forecasts: Information Technology (22.3%), Financials (18.3), Real Estate (16.2), Telecom (13.2), Utilities (12.1), S&P 500 (12.0), Materials (11.4), Health Care (11.1), Industrials (10.1), Consumer Discretionary (8.1), Consumer Staples (7.1), and Energy (6.3).

S&P 500 Q1 Earnings Trend vs. Past Quarters ([link](#)): With the March-quarter books closed, the current Q1-2018 EPS forecast of \$34.42 has gained an impressive 5.1% over the 13 weeks since the quarter's start, primarily due to the positive impact of the TCJA. That's the best gain since it rose 5.4% during Q2-2004 and the second best gain on record in the 96 quarters dating back to 1994. That gain compares to an average decline of 4.2% over the same time period since 1994 and a 0.4% decline during Q4-2017. Analysts expect EPS for Q1-2018 to be up 17.0% y/y on a frozen actual basis, which would mark the seventh straight quarter of higher EPS on a y/y basis and would beat the 15.2% gain for Q4-2017 (the strongest growth since Q3-2011). Since 1994, the Q1 earnings surprise has been positive in 23/24 years (all but Q1-2008 during the height of the financial crisis). We think Q1 will mark the S&P 500's record 37th straight quarter of positive surprises—a streak dating back to Q1-2009, and its strongest y/y growth since Q4-2010 came in at 34.2%.

US ECONOMIC INDICATORS

ADP Employment ([link](#)): "The job market is rip-roaring. Monthly job growth remains firmly over

200,000, double the pace of labor force growth. The tight labor market continues to tighten,” according to ADP. In March, private industries added 241,000 to payrolls—the fifth straight month of increases of 200,000 or more—following an upward revision to February (to 246,000 from 235,000) and a slight downward revision to January (241,000 from 244,000), for a net gain of 8,000. Service-providing industries (176,000) accounted for over 70% of March’s gain, though goods-producing industries (65,000) registered another strong performance, driven by both construction (31,000) and manufacturing (29,000) jobs—with the latter posting its biggest monthly gain in more than three years. Over the past 15 months, construction and manufacturing jobs have increased 318,000 and 235,000, respectively. Within service-providing industries, the increase was broad based, with professional & business services (44,000), trade, transportation & utilities (40,000), health care & social assistance (29,000), and leisure & hospitality (26,000) all posting solid gains. By company size, medium-sized companies remained at the top of the leader board, adding 127,000 jobs—the most since October 2014—with 87,000 service-providing and 40,000 goods-producing. Large companies (67,000) held the number two spot, with a mix of 53,000 service-providing jobs and 14,000 goods-producing ones. Small companies once again finished third, adding 47,000 to payrolls—36,000 service-providing and 11,000 goods-producing.

GLOBAL ECONOMIC INDICATORS

Eurozone CPI Flash Estimate ([link](#)): March’s CPI rate is expected to move up to 1.4% y/y, according to the flash estimate, after slowing steadily from November’s 1.5% to a 14-month low of 1.1% in February. So March’s rate should remain below the ECB’s goal of just under 2.0%. Looking at the main components, rates for food, alcohol, and tobacco (to 2.2% from 1.0% y/y) and services (1.5 from 1.3) should accelerate, partially offset by a deceleration in non-energy industrial goods (0.2 from 0.6) and energy (2.0 from 2.1). The core rate—which excludes energy, food, alcohol, and tobacco—is expected to be at 1.0% for the third month.

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