



MORNING BRIEFING

April 12, 2018

Earnings, Genes & Brazil

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

(1) What do earnings, genes, and Brazil have in common? They're all remarkable. (2) Get ready for a great Q1 reporting season. (3) Q1 earnings growth in high teens expected; analysts see roughly 20% growth in 2Q, 3Q, and 4Q. (4) Analysts have been upping earnings sights dramatically, for Q1 and 2018, across nearly all sectors. (5) Novartis pays up to beef up its gene-editing capabilities with acquisition of AveXis. (6) Brazil's MSCI Index has stumbled in April as presidential contender Lula heads off to the clinker. (7) A lulu of a buying opportunity?

Strategy: Q1 Earnings. Nobody likes to talk about their failures, but the persistence it takes to overcome failure can be more transformative than any success. Some high-profile failures: Michael Jordan was cut from his high school basketball team for not being good enough. Dr. Seuss's first book was rejected by 27 publishers before it was accepted. And Thomas Edison was told growing up that he was too stupid to learn anything.

The S&P 500 has failed to make new highs since hitting its January peak. But it managed to clear some pretty important hurdles this week. China's President Xi Jinping offered to further open China's markets, jump-starting investors' hope that a trade war can be averted. Then Facebook CEO Mark Zuckerberg held his own while being grilled for hours on company practices by members of Congress.

As the week draws to a close, amazingly strong Q1 earnings reports are expected to start rolling in. Industry analysts polled by Thomson Reuters are expecting that S&P 500 companies' earnings jumped by 18.5% y/y in Q1, with S&P's frozen actual methodology showing expected growth of 17.0% ([Fig. 1](#)). Thomson Reuters' number comes down only slightly, to 16.7%, if Energy sector earnings—expected to pop—are backed out of the mix. Let's take a deeper dive into what's expected during the Q1 reporting season:

(1) *Top line looks good.* Undoubtedly, the Trump tax cuts are boosting companies' bottom lines. But the overall strength in the economy shouldn't be underappreciated. Analysts currently estimate that S&P 500 Q1 revenues grew 7.3% y/y, and there's no reason to believe they were directly boosted by the tax cuts enacted at the end of last year.

The expectation for Q1 earnings growth has jumped roughly six percentage points since the beginning of the year, when it was 12.2%. Estimates for Q1 revenues haven't increased as sharply. They were expected to grow by 7.0% during Q1 at the start of the year, versus the current 7.3% estimate.

(2) *Broad-based growth.* All 11 S&P 500 sectors are expected to see Q1 earnings grow y/y. Here's the derby for the S&P 500 sectors' expected Q1 revenues and earnings growth, (ranked by earnings): Energy (14.5%, 70.8%), Materials (11.6, 27.0), Financials (3.0, 24.6), Tech (13.9, 23.4), S&P 500 (7.3, 18.5), Industrials (7.5, 14.1), Telecom (4.0, 12.8), Health Care (6.4, 11.0), Consumer Staples (4.4, 10.7), Utilities (1.9, 9.8), Consumer Discretionary (6.5, 9.4), and Real Estate (6.9, 2.9).

The Energy sector is expected to have the largest pop thanks to the jump in the price of a barrel of Brent crude oil to \$71.95 yesterday from \$56.23 a year ago. Q1 earnings estimates for the Energy sector have improved 15.4% since December 29, 2017. All the other sectors except Real Estate also saw earnings estimates improve since year-end.

Here's how consensus earnings estimates for Q1 have changed since year-end: Energy (15.4%), Telecom Services (14.4), Financials (11.8), Utilities (6.4), Consumer Discretionary (4.5), Health Care (3.9), Industrials (3.6), Consumer Staples (2.1), Tech (1.2), Materials (0.5), and Real Estate (-6.8) ([Fig. 2](#)).

(3) *Forward estimates improving too.* The Energy sector has also enjoyed the largest percentage increase in forward earnings over the last 13 weeks, 21.2%. The Oil & Gas Drilling industry's forward earnings has turned positive for the first time since March 2016, and the Oil & Gas Exploration & Production industry's forward earnings has improved by 66.6% ([Table 1](#)).

Outside of the Energy sector, the wide array of industries that top the list of most improved forward earnings estimates over the past 13 weeks attests to the economy's broad-based strength: Department Stores (27.6%), Trucking (20.1), Construction & Engineering (21.5), Railroads (17.7), General Merchandise Stores (19.1), Aerospace & Defense (18.5) and Homebuilding (14.6). The only sector to have its forward earnings estimates cut is Real Estate, with a 2.8% decline.

Assuming a trade war will be averted, as we do, the good times are expected to continue for the remaining quarters of 2018. Analysts are calling for S&P 500 earnings to grow by 19.7% in Q2, 22.1% in Q3, and 19.1% in Q4. Even when comparisons get more difficult in Q1-2019, earnings are forecasted to rise 10.6%. These growth rates would continue to push earnings to new record highs. Our message to the S&P 500: If at first, second, and third, you don't succeed to rebound back to new highs, try, try, and try again.

Health Care: Gene Editing. We [recently](#) extolled the virtues of the advancements in the world of gene editing. The latest endorsement of the area came this week when Novartis announced plans to spend \$8.7 billion to purchase AveXis—an 88.1% premium to the company's market cap.

AveXis is in the midst of trials on AVXS-101, a treatment for spinal muscular atrophy, a childhood muscle-wasting disease caused by a defect in a single gene. Nine of 10 infants with the disease do not reach their second birthday or are permanently dependent on ventilators, a 4/9 *FT* [article](#) explained. AveXis uses a virus to insert DNA into cells. Its treatment has been tested on only 15 patients, but the company hopes to file the treatment with the FDA in the second half of this year and aims for a launch in 2019.

Novartis is already well versed in the world of gene editing. Its Kymriah therapy was approved by the FDA last summer to fight an aggressive leukemia in children and young people. With Kymriah, genes that recognize specific cancer cells are inserted into white blood cells taken out of the patient. "The genes reprogram the [white blood cells] to produce specific 'chimeric antigen receptors'—or CARs—on their surface, which are attracted to malignant proteins on the surface of a cancer cell," a 9/30 *WSJ* [article](#) reported. The modified cells are grown in a lab for 10 days, while the patient receives chemotherapy. The new white blood cells are infused back into the patient, where they multiply and kill cancer cells. The cost per treatment: \$475,000.

Novartis has also partnered with Spark Therapeutics, which has the only FDA-approved gene therapy for a retinal condition that leads to blindness, a 4/9 *Barron's* [article](#) pointed out. Novartis has the non-

US rights to Luxturna, Spark's treatment, which is priced at \$850,000 for both eyes.

In addition to a new therapy, the purchase of AveXis gives Novartis new manufacturing capabilities. A 4/9 [article](#) in *The Pharma Letter* explained: "AveXis also offers state of the art AAV9 gene therapy manufacturing capabilities and valuable R&D capabilities, which in addition to AVXS-101, includes other pipeline products for Rett Syndrome and a genetic form of amyotrophic lateral sclerosis caused by mutations in the superoxide dismutase 1 gene. AAV9 is considered to be a clinically proven gene delivery platform for diseases of the central nervous system." Looks like Novartis is putting a stake in the gene-therapy ground.

Brazil: Bye Bye, Lula. Brazil was a top performer in the MSCI share price indexes last year, returning 23.3% (in local currency) in 2017 as the country emerged from its worst recession in 25 years. Much of the gain came in the second half of the year: The MSCI Brazil Share Price Index rose 19.1% (in Brazilian real) from June 30 through year-end 2017. Investors looked past corruption scandals and political upheaval and focused on improving economic fundamentals and impressive earnings forecasts. The performance bested the 19.2% (local currency) increase turned in by the MSCI Emerging Market Latin American share price index in 2017 as well as the 19.4% (dollars) rise in the S&P 500 share price index.

Our [Morning Briefing](#) alerted folks to the changing economic climate in Brazil and pointed out the main drivers of growth. So far in 2018, Brazil's stock market has continued its show of strength. Its local currency gain of 10.2% ytd through Tuesday makes it the third-best-performing MSCI share price index, behind only Pakistan and Peru. For Q1, its 11.4% advance was second only to Pakistan's performance.

Still, April is proving to be a bumpy ride. Brazil is among the month's worst performers, down 1.1% month to date. Monday, the benchmark Bovespa stock index dropped nearly 2.0% and the currency fell 1.5% against the dollar to BRL3.4201, a level last touched in December 2016, according to a 4/9 [report](#) in the *Financial Times* ([Fig. 3](#) and [Fig. 4](#)).

The cause: Former President Luiz Inácio Lula da Silva, a front-runner in this year's presidential race, surrendered to authorities Saturday after an initial standoff following a ruling by Brazil's top court last week that he must serve a 12-year prison sentence for corruption even as he appeals the conviction.

The uncertainty surrounding the coming October presidential election, with no clear favorite, has unsettled investors. There are concerns, too, that the much-needed market reforms remain elusive. But it's important to point out that the Bovespa also gained 2.0% the day after the Supreme Court handed down its ruling on Lula's jail sentence. At 84,510 at Tuesday's close, the Bovespa is just off its all-time closing high of 87,652 reached February 26 and thus presumably susceptible to profit-taking. Threats of US-imposed tariffs and increasing volatility are unnerving investors too.

However, Brazil's economy powered ahead in the past year despite the never-ending drumbeat of corruption and scandal. Let's look behind the headlines and see what the numbers say about the outlook for the largest economy in Latin America:

(1) *GDP growth.* Brazil's real GDP expanded 1.0% for the full-year 2017, after contracting 3.5% in each of the previous two years, buoyed by falling unemployment, low inflation, record-low interest rates, and rising household consumption. Q4 growth registered 2.1% on an annual basis, boosted by stronger gross fixed investment ([Fig. 5](#)).

But the figure was below the 2.5% estimate, negatively impacted by the strength in the Brazilian real, which hurt exports overall, and a smaller agricultural harvest, according to a 3/1 Reuters [article](#).

Finance Minister Henrique Meirelles reiterated that the economy is on track to grow 3.0% this year.

(2) *Industrial production.* Weakness in extraction and mining, down 5.2% for the month, and pharmaceuticals, down 8.1%, led to a modest uptick of 0.2% m/m (saar) in industrial production in February, noted investment bank Itau BBA, in a 4/3 [piece](#). On a y/y basis, industrial output rose 2.8%, sharply lower than the 5.8% reported in January ([Fig. 6](#)).

(3) *Consumer prices.* Inflation in March was 2.68% y/y, holding near its lowest yearly rate since 1999. Prices rose 0.09% m/m, the lowest March increase in 24 years, as consumer prices continued to soften, led by declines in transportation and communications, according to a 4/10 [report](#) in the *Rio Times*, based on data released by the Brazilian Institute of Geography and Statistics ([Fig. 7](#)). Inflation remains solidly below the central bank's target of 4.50%, plus or minus 1.50%, despite a series of cuts aimed at stimulating growth. Most recently, the central bank eased interest rates by 0.25% on March 21 to a record low of 6.50%, marking the 11th straight time it has reduced rates. For a sense of the magnitude of the cuts, consider that in October 2016 rates stood at 14.25%. The central bank has said it is prepared to ease again in May if conditions warrant ([Fig. 8](#)).

(4) *Consumer confidence.* The consumer confidence index published by the Getulio Vargas Foundation, or FVG, unit of the Brazilian Institute of Economics showed a seasonally adjusted rise of 5.3% m/m in March, according to a 3/23 [report](#) in RTTNews. The index rose to 92.0 in March from 87.5 in February, the best reading since September 2014. Spanning a range of 1-200 points, with 100 considered neutral, the latest reading shows consumer sentiment still lies in pessimistic territory but is increasingly optimistic. The expectations index climbed by 5.0 points to 101.5, the highest reading since December 2013 ([Fig. 9](#)).

(5) *Deals.* The \$14.5 billion takeover of Fibria Celulose by Suzano Papel e Celulose announced March 19 is the largest involving a Brazilian target company in Brazil's history, and among the top 10 global deals by value in Q1, according to a 4/5 [article](#) in the *Financial Times*. Notably, the deal was driven by competitive forces and not the result of deleveraging or a forced sale related to a corruption scandal that has marked so many Brazilian transactions in recent years. Another healthy sign: A consortium of international banks is providing \$9.2 billion to Suzano for the purchase, attracted by the stronger economic growth and low interest rates.

Among other major deals in the works is the potential merger of aerospace rivals Brazil's Embraer and U.S.-based Boeing, which have been in talks since December. Also, state-controlled oil company Petrobras is selling a 90% stake in its gas pipeline network Transportadora Associada de Gás, or TAG, for about \$8 billion.

(6) *IPOs.* Payment processor PagSeguro Digital LTD raised \$2.27 billion in a heavily subscribed January IPO on the NYSE, selling shares at \$21.50, above the top of the offering's \$17.50-\$20.50 price range, a 1/24 [article](#) on Bloomberg noted. It represented the largest IPO by a Brazilian company since insurer BB Seguridade's IPO in the local market in 2011. It was the largest IPO on the NYSE since Snap raised \$3.4 billion in its March 2017 IPO.

IPOs in the pipeline for later this month include shoemaker Dass Nordeste, seeking to raise up to \$300 million, as well as online bank Banco Inter, hoping to raise more than \$200 million, and healthcare provider Notre Dame Intermédica Participações S.A., hoping to raise \$546 million or more. Still, investors are being selective: Toymaker Ri Happy Brinquedos, controlled by the Carlyle Group, postponed a planned IPO last month after meeting with weak investor interest following Toys R Us' decision to shutter its stores in the wake of filing for bankruptcy protection.

(7) *Valuation*. With an earnings growth rate of 21.1% estimated for this year and earnings forecasts climbing amid a rise in positive earnings revisions, the MSCI Brazil's forward P/E of 12.2 makes this market look very attractive. It may no longer have Lula as a presidential contender, but Brazil is looking like a lulu of an investment!

CALENDARS

US. Thurs: Jobless Claims 230k, Import & Export Prices 0.2%/0.3%, Weekly Consumer Comfort Index, EIA Natural Gas Report. **Fri:** Job Openings 6.143m, Consumer Sentiment Index 101.0, Baker-Hughes Rig Count. (*Wall Street Journal* estimates)

Global. Thurs: Eurozone Industrial Production 0.1%*m/m*/3.6%*y/y*, BOE Credit Conditions & Bank Liabilities Surveys, ECB Publishes Account of March Meeting, Carney, Kuroda, Yi Gang. **Fri:** Eurozone Trade Balance €27.9b, Germany CPI 0.4%*m/m*/1.6%*y/y*, China Trade Balance \$27.9b. (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 fourth week from 3.50 to 2.27 over the period—the lowest since November 2016. Twelve weeks ago, it was at 5.25—which was the highest reading since early April 1986. Bullish sentiment dropped for the third week to 42.2%, 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 third week to 39.2% this week (the highest since May 2016) after falling from 37.5% to 27.7% the prior three weeks. Bearish sentiment climbed for the sixth week from 14.4% to 18.6% over the period, after little change the prior few weeks. The AAI Ratio declined for the third week last week from 63.3% to 46.5% over the period. Bullish sentiment held at 31.9% last week, after falling 4.9ppts the prior two weeks (from 36.8%), while bearish sentiment rose from 21.3% to 36.6% over the three-week span.

S&P 500 Earnings, Revenues & Valuation ([link](#)): Last week saw S&P 500 consensus forward revenues and earnings rise for a second week to record highs. The 2018, 2019, and forward profit margin forecasts were steady w/w at 11.8%, 12.4%, and 12.0%, respectively. Prior to the passage of the TCJA in December, 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. The annual growth expectations for revenues and earnings were steady w/w, but their forward growth calculations declined as increasing weight was attributed to next year's growth. Forward earnings growth dropped 0.8ppt w/w to 15.5%. That's down from 16.9% in February, which was the highest since October 2010, but it's up 4.4ppts from 11.1% prior to the passage of the TCJA, and up 11.5ppts from the cyclical low of 4.8% in February 2016. Among the 11 sectors, the forward earnings growth forecast weakened for nine, improved for Real Estate, and was steady for Utilities. 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 dropped by 0.1ppt to 5.5% for revenues and fell 0.7ppt to 14.3% for earnings. However, 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 edged up to 16.4 from 16.3, 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 improved to 1.97 from 1.95, which compares to late January's record high of 2.16.

S&P 500 Sectors Earnings, Revenues & Valuation ([link](#)): Consensus forward revenues and earnings

forecasts rose last week for all 11 sectors. 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 are 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 recent highs for all sectors, but all improved w/w with the exception of Real Estate and Utilities. 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 1.20 compares to a record high of 1.56 in May 2016, and its P/E of 19.0 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. Five sectors posted a 0.1% gain w/w in their forward profit margin: Financials, Health Care, Materials, Real Estate, and Tech. Utilities was the sole decliner. Here's how the sectors rank based on their current forward profit margin forecasts: Information Technology (22.4%), Financials (18.4), Real Estate (16.3), Telecom (13.2), Utilities (12.0), S&P 500 (12.0), Materials (11.5), Health Care (11.2), 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 14 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. Based on S&P's survey, analysts expect EPS for Q1-2018 to be up 17.0% y/y on a frozen actual basis, and Thomson Reuters' survey pegs growth at 18.5%. Either way, that 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

CPI ([link](#)): The core CPI rate in March rose above the Fed's target rate of 2.0% y/y for the first time since February 2017. March's CPI accelerated 2.1% y/y after fluctuating between 1.7% and 1.8% the prior ten months. Meanwhile, the three-month rate slowed slightly to 2.8% (saar), after accelerating 3.1% during the three months ending February—which was the fastest since January 2008. On a monthly basis, core prices rose 0.2%, matching February's rate, after posting a 0.3% gain at the start of the year. Along with shelter and medical care costs, prices for personal care, motor vehicle insurance, and airfares also rose last month; they were partially offset by declines in apparel, communications, and used car & truck prices. Falling gasoline prices pushed the headline CPI down 0.1%, the first monthly decline since last May; the yearly rate accelerated from 2.2% to 2.4% y/y—the highest in a year.

GLOBAL ECONOMIC INDICATORS

France Industrial Production ([link](#)): Headline industrial production rebounded in February, while manufacturing output fell unexpectedly for the fourth straight month. Headline production, which excludes construction, jumped 1.2% in February after sinking 1.8% in January, as electricity output jumped 13.3% after unseasonably warm weather triggered a 6.9% drop in January. Meanwhile, manufacturing production declined for the fourth month, by 0.6% in February and 2.4% from October's cyclical high. Both capital and intermediate goods output fell for the third time in four months by a total of 2.9% and 2.5%, respectively. Meanwhile, consumer durable goods production plummeted 8.6% during the first two months of this year after jumping 10.4% during the final two months of last year;

consumer nondurable goods output rose 1.2% in February after a three-month decline of 3.4%. March's IHS Markit M-PMI slowed for the third month, from 58.8 in December to 53.7, as expansion in output and new orders slowed markedly last month.

Italy Industrial Production ([link](#)): Output in Italy slumped the during first two months of this year, after a strong finish in the final months of 2017 that lifted production to its highest level since May 2011. Production, excluding construction, dipped 0.5% after a 1.8% drop in January; it had jumped 3.4% during the three months ending December. Manufacturing production fell 3.7% during the first two months of this year on widespread weakness. Capital (-2.6%), intermediate (-2.5), and consumer (-2.3) goods production all contracted over the two-month period. Italy's M-PMI fell for the second month, from a near seven-year high of 59.0 in January to an eight-month low of 55.1 in March—still comfortably above its historical average. According to the March report, both production and new orders increased markedly last month, though at slower rates.

UK Industrial Production ([link](#)): UK industrial output slowed in February after wide swings the prior two months. Production edged up only 0.1% in February after a 1.3% gain and a 1.2% loss the prior two months—reflecting a temporary shutdown of a North Sea oil pipeline in December and the reopening in January. Prior to this disruption, production had increased 2.8% the prior eight months. Meanwhile, manufacturing output fell 0.2% in February after no change in January; it had increased 3.1% the last eight months of 2017, to a new cyclical high. Despite the recent weakness in factory output, capital goods production rose 2.9% in the three months through February, while consumer durable goods output was up 4.6% over the past four months—with the former at a new record high. The biggest drag was a 2.2% drop intermediate goods production over the past three months. IHS Markit's M-PMI for March signaled steady growth—ticking up from 55.0 to 55.1—with manufacturing production advancing for the 20th successive month in March, at the sharpest rate so far this year.

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