Yardeni Research

MORNING BRIEFING
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The Longest Expansion

See the collection of the individual charts linked below.

(1) A short review of the supply-side religion. (2) The central dogma: Tax cuts pay for themselves. (3) Fact-based vs faith-based economics. (4) Some of the supply-side stimulus leaks out through the widening trade deficit. (5) Supply-side stimulus in a fully employed economy can increase net interest cost for the government. (6) Fed officials thinking out loud about fiscal policy stimulus. (7) Index of Coincident Economic Indicators shows economy still growing around 2.0%. (8) Yield curve is just one of 10 components of Index of Leading Economic Indicators. (9) No boom, no bust. (10) This expansion has a shot at the record books.

US Economy I: Leaky Supply-Side Logic. Debbie and I would like to believe that Trump's cuts in marginal tax rates for individuals and corporations will boost economic growth. They will do so presumably because we all have a greater incentive to work harder since we get to keep more of our incomes. Higher growth would then boost tax revenues for the government. Those additional revenues should offset the receipts lost by cutting marginal tax rates. This is the stripped-down version of the supply-siders' explanation for why lower tax rates should generate more growth and basically "pay for themselves." Since we practice fact-based, rather than faith-based, economics, we have to see it to believe it.

We are waiting to see some signs that the supply-siders are on the right track. We aren't seeing any yet, though it has been only four months since the Tax Cuts and Jobs Act (TCJA) was enacted in December 2017. Part of the problem is that some of the TCJA's stimulative effect on GDP leaks through the trade deficit. That's because some of the tax windfalls received by consumers and businesses are spent on buying more imported goods and services. Another problem is that the TCJA is stimulating an economy that's arguably at full employment. In the past, such fiscal stimulus typically occurred at the tail end of recessions or early in recoveries.

The minutes of the March 20-21 FOMC meeting suggested that Fed officials would consider raising interest rates at a faster pace if fiscal policy started to overheat the economy. That would boost the net interest expense of the mounting debt of the federal government. This interest-cost effect could offset a significant portion of the revenues effect touted by supply-siders.

Let's have a closer look at the Fed's perspective on fiscal policy. The word "fiscal" appeared 10 times in the latest FOMC minutes. Here is a sampling:

(1) *Survey of dealers.* "Respondents to the Open Market Desk's surveys of primary dealers and market participants suggested that revisions in investors' views regarding the fiscal outlook were an important factor boosting yields and contributing to a slightly steeper expected trajectory of the federal funds rate."

(2) *Staff projections.* "The staff saw the risks to the forecasts for real GDP growth and the

unemployment rate as balanced. On the upside, recent fiscal policy changes could lead to a greater expansion in economic activity over the next few years than the staff projected. On the downside, those fiscal policy changes could yield less impetus to the economy than the staff expected if the economy was already operating above its potential level and resource utilization continued to tighten, as the staff projected."

(3) *Participants.* "Tax changes enacted late last year and the recent federal budget agreement, taken together, were expected to provide a significant boost to output over the next few years. However, participants generally regarded the magnitude and timing of the economic effects of the fiscal policy changes as uncertain, partly because there have been few historical examples of expansionary fiscal policy being implemented when the economy was operating at a high level of resource utilization."

(4) *Members (who vote).* "In addition, notwithstanding increased market volatility over the intermeeting period, financial conditions had stayed accommodative, and developments since the January meeting had indicated that fiscal policy was likely to provide greater impetus to the economy over the next few years than members had previously thought."

The risk in all this is a scenario where economic growth doesn't pick up as the supply-siders expect it to but interest rates move higher as a result of the larger federal deficits and the perception that Trump's fiscal stimulus might boost inflation. We expect only a short-term boost to growth from the tax cuts. We also believe inflation will remain subdued. In short, as discussed in the next section, we don't expect an inflationary boom. If we're right, then the current expansion may continue for some time.

US Economy II: Stall Speed & Inverted Yield Curve. Data for Q1-2018 real GDP will be released on Friday, April 27. The Atlanta Fed's GDPNow model predicts 2.0% q/q (saar) based on data available through April 17. That would put the y/y rate at 2.8%. Debbie and I prefer the y/y metric because it solves the annoying "residual" seasonality problem that has plagued the Q1 figure, which has tended to be weaker than the other quarters' figures since 2010 (*Fig. 1*). On a y/y basis, real GDP growth has consistently meandered around 2.0% since 2010, with a low of 1.0% and a high of 3.2% (*Fig. 2*).

Also meandering around 2.0% has been the y/y growth rate of the Index of Coincident Economic Indicators (CEI) (*Fig. 3*). It's not a coincidence that this growth rate closely tracks the comparable growth rate in real GDP. The CEI was up 2.2% y/y through March. During 2010, pessimistically inclined economists observed that 2.0% growth had been the economy's stall speed during all expansions since WWII. In other words, 2.0% growth meant a recession was likely to occur soon. It's eight years later now, and real GDP still is growing around its purported stall speed without stalling.

This demonstrates that while history often repeats itself, there are exceptions. So if the stall speed concept isn't working, then perhaps the following widely believed notion might also be wrong this time: A flattening yield curve signals an inversion in the shape of the yield curve, which signals recession. In the past, that's held true, but Debbie and I don't see a recession anytime soon. Consider the following:

(1) *Leading indicators.* The Index of Leading Economic Indicators (LEI) first rose above its previous cyclical high during March 2017 and hasn't looked back since then. That's relatively recent, and suggests that the LEI has time to climb higher in record-high territory, as it has in the past (*Fig. 4*). Keep in mind that the yield curve spread is actually just one of the 10 components of the LEI!

(2) *Coincident indicators.* Back in 2014, we predicted that the next recession wouldn't happen sooner than 2019. We based that on our observation that the average length of economic expansions after they recovered above the previous cyclical high was 65 months over the previous five cycles (*Fig. 5*). The CEI started making record highs again during February 2014. Using the average of the past five

cycles as a benchmark would place the next business cycle peak during March 2019.

(3) *Boom-Bust Model.* In Chapter 5 of my new book, *Predicting the Markets: A Professional Autobiography*, I discuss my Boom-Bust Model of the business cycle. The bottom line is obvious: Booms set the stage for busts, so if there is no boom, then there will be no bust. During booms, financial excesses mount. Too much debt finances too much business activity. The resulting inflationary and speculative excesses cause interest rates to rise to levels that burst the debt-fueled bubble. A financial crisis occurs, triggering a credit crunch, which causes a recession. Most recessions coincide with a financial crisis (*Fig. 6*).

(4) *Long expansions.* The CEI data start in 1959 (*Fig. 7*). There have been eight economic expansions since then. The current economic expansion has lasted 105 months through March. That makes it the third longest of the eight expansions. It will be the second longest during May, and the longest of them all in July 2019. We think it has a shot at making the record books. The LEI remains bullish on the outlook for real GDP even though one of its 10 components (the yield curve) has raised widespread concern (*Fig. 8*). We remain bullish on the outlook for this expansion and for stocks.

CALENDARS

US. **Tues:** Consumer Confidence Index 127.0, Richmond Fed Manufacturing Index 16, New Home Sales 630k, FHFA Home Price Index 0.5%, S&P Corelogic Case HPI 0.7%m/m/6.2%y/y. **Wed:** MBA Mortgage Applications, EIA Petroleum Status Report. (*Wall Street Journal* estimates)

Global. **Tues:** Germany Ifo Business Climate, Current Assessment, and Expectations Indexes 102.8/106.0/99.5, Australia CPI 2.0% y/y. **Wed:** None. (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—fell for the fifth week since reaching a new record high during the week of March 10. Since then, the WLI is down 1.9% during the five weeks ending April 14, after climbing eight of the prior nine weeks by a total of 8.2%. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). Our BBB contracted 3.6% over the five-week period, following a nine-week jump of 13.0%. Jobless claims, one of the components of our BBB, rose for the fifth week to 231,250 (4-wa), still not far from the 222,750 reading five weeks ago—which was the lowest level since 1973. Meanwhile, the CRB raw industrial spot price index, another BBB component, remains in a volatile flat trend around recent highs, moving up to the middle of the range. The WCCI is at its highest readings since 2001.

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose to record highs last week for all three indexes. LargeCap's forward earnings has been up in 38 of the past 39 weeks, MidCap's was higher last week for a 34th straight week (which now exceeds its prior record streak in mid-2002), and SmallCap's has been up in 32 of the past 35 weeks. Earnings momentum remains healthy, as the yearly change in forward earnings is up from six-year lows in early 2016 and should remain strong in 2018. In the latest week, the rate of change in LargeCap's forward earnings rose to 20.0% y/y from 19.8% y/y, which is down slightly from a seven-year high of 20.3% in mid-March and compares to a six-year low of -1.8% in October 2015; MidCap's dropped to 23.1% from 23.5%, which compares to a seven-year high of 24.0% in mid-March and a six-year low of -1.3% in December 2015; and SmallCap's ticked down to 27.2% from 27.5%, which compares to a seven-year high of 27.7% in early April and a six-year low of 0.3% in December 2015. Here are the latest consensus earnings growth rates for 2018 and 2019: LargeCap 19.9% and 10.0%, MidCap 19.6% and 12.1%, and SmallCap 22.8% and 17.4%.

S&P 500/400/600 Forward Valuation (*link*): Last week saw forward P/E ratios improve for all three indexes for a second week from post-election lows. LargeCap's weekly forward P/E rose to 16.4 from 16.3 in the prior week, but is down from 18.6 on January 26—the highest since May 2002. These recent levels are up from a post-election low of 16.0 in late March and the post-Lehman-meltdown P/E of 9.3 in October 2008, but remain well below the tech-bubble record high of 25.7 in July 1999. MidCap's forward P/E rose to 16.4 from 16.3 and a 25-month low of 16.1 the week before that, but remains down from a 15-year high of 19.2 in February 2017 and the record high of 20.6 in January 2002; however, it is up from a three-year low of 15.0 in January 2016. MidCap's P/E has been at or below LargeCap's P/E since August for the first time since 2009. SmallCap's P/E improved to 17.6 from 17.5, which compares to a post-election low of 17.0 in mid-March. That's 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 forward price/sales (P/S) ratios, the three indexes were higher w/w and remain well below their recent highs in January: LargeCap's P/S of 2.02 is down from a record high of 2.19 on January 26; MidCap's 1.30 compares to its record high of 1.40, also on January 26; and SmallCap's 1.00 is down from 1.05 then, which 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 quarterly earnings reporting season underway, the Q1-2018 earnings forecast rose w/w during a period when forecasts typically move higher due to positive surprise bias. The S&P 500's Q1-2018 EPS forecast rose 30 cents w/w to $36.45, which is up 7.3% since the end of Q4 and 8.1% since the passage of the TCJA. The $36.45 estimate represents a forecasted pro forma earnings gain for Q1-2018 of 20.0%, which compares to Q4-2017's 14.8%, 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 nine sectors and down for one. Energy's Q1 forecast has jumped 15.8%, followed by the forecasts for Telecom (up 14.4%), Financials (11.9), and Utilities (6.6). Real Estate is the sole decliner, with its Q1-2018 forecast down 6.8%, followed by Materials (0.0), Tech (1.1), Consumer Staples (2.1), Industrials (3.6), Health Care (3.9), and Consumer Discretionary (4.1). The S&P 500's Q1-2018 forecasted earnings gain of 20.0% 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 nine rising at a double-digit percentage rate—and four are expected to beat the S&P 500's forecasted y/y earnings gain of 20.0%. 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 Q4-2017 growth rates: Energy (69.9% in Q1-2018 vs 120.4% in Q4-2017), Financials (29.5, 14.6), Materials (27.5, 35.9), Tech (23.6, 20.1), S&P 500 (20.0, 14.8), Industrials (17.6, 1.8), Telecom (12.4, 4.8), Health Care (11.8, 9.1), Consumer Staples (11.4, 12.1), Utilities (11.1, 13.0), Consumer Discretionary (9.4, 10.7), and Real Estate (2.9, -4.1). On an ex-Energy basis, S&P 500 earnings are expected to rise 18.3% y/y in Q1, up from a 12.7% 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 Q1 Earnings Season Monitor (*link*): With over 18% of S&P 500 companies finished reporting earnings and revenues for Q1-2018, the percentage of companies with positive surprise results are lower compared to the same point during the Q4 earnings season, but their overall surprise and y/y growth metrics are stronger. Of the 92 companies in the S&P 500 that have reported, 77% exceeded industry analysts' earnings estimates by an average of 6.0%; they have averaged a y/y earnings gain of 27.3%. At the same point during the Q4-2017 reporting period, a slightly higher percentage of companies (78%) in the S&P 500 had beaten consensus earnings estimates by a lower 4.2%, and earnings were up a lower 15.6% y/y. On the revenue side, 69% beat sales estimates so far, with results coming in 1.6% above forecast and 10.5% higher than a year earlier. At this point in the Q4 season, a higher 84% had exceeded revenue forecasts by a lower 1.4%, and sales rose a lower 8.1% y/y. Q1 earnings results are higher y/y for 91% of companies vs a lower 80% at the same point in Q4, and revenues are higher y/y for 91% during Q1 vs 93% a quarter ago. These figures will change markedly as more Q1-2018 results are reported in the coming weeks. The early results on revenues are very encouraging, particularly the percentage of companies growing revenues y/y. Q1-2018 should mark the seventh straight quarter of positive y/y earnings growth and the strongest since Q4-2010 in part due to lower tax rates.

GLOBAL ECONOMIC INDICATORS

US PMI Flash Estimates (*link*): US manufacturers reported the strongest growth in 43 months in April, according to flash estimates, while service-sector growth continued to bounce around recent highs. April's C-PMI climbed from 54.2 in March to 54.8 this month, heading back toward February's 13-month high of 55.8—supported by the fastest new orders growth since March 2015. The M-PMI climbed for the fourth time in five months, from 53.9 in November to 56.5 this month—the best since September 2014—led by marked expansions in output and new orders, with the latter expanding at its fastest pace in over 3.5 years. The NM-PMI (54.4 from 54.0) showed a slightly faster upturn in business activity, as the rate of growth in new business for service providers was the best in just over three years. Input price inflation for goods and services was the fastest since July 2013, with respondents noting that the introduction of tariffs had been a key factor pushing raw materials prices higher.

Eurozone PMI Flash Estimates (*link*): "Eurozone economy stays in lower gear as PMI holds steady in April" is the headline of the latest IHS Markit's survey release. April's C-PMI was unchanged at March's 14-month low of 55.2 this month, according to the flash estimate, after reaching a 139-month high of 58.8 in January. The manufacturing sector continued to grow at a faster pace than the service sector, though the M-PMI (to 56.0 from 56.6) showed the rate of growth in the former slowed to a 14-month low this month, while the NM-PMI (55.0 from 54.9) showed growth in the service sector was slightly faster than March's seven-month low. Output growth across both sectors has decelerated sharply since an 11.5-year peak at the start of this year, in line with the slowdown in new orders, which expanded at the weakest rate in 15 months. Employment continued to grow at an elevated rate, though slower than that recorded at the turn of the year. Factories reported the weakest gain in both total goods orders and export orders in a year and a half, with the latter impacted by the stronger euro. Meanwhile, new business inflows in the service sector slipped to an eight-month low. By country, C-PMIs show that growth picked up slightly this month in both France (56.9 from 56.3) and Germany (55.3 from 55.1), but in both cases remained below February levels. France's expansion was the second weakest in the past eight months, Germany's the second weakest in the past nine months—with manufacturing the main drag in France this month and the service sector the main drag in Germany. Growth in the rest of the Eurozone slowed to an 18-month low, with both manufacturing and services recording weaker expansions.

Japan M-PMI Flash Estimate (*link*): Japan's manufacturing sector expanded at a slightly faster pace in April, according to its flash estimate. The M-PMI ticked up to 53.3, after easing the previous two months from a four-year high of 54.8 in January to 53.1 in March, as new orders, output, and employment all rose faster. However, the strong yen triggered a contraction in new export orders this month, tempering the acceleration in other components.

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