MORNING BRIEFING

May 2, 2018

Peak Earnings Sense & Nonsense

See the collection of the individual charts linked below.

(1) Has the market discounted "peak earnings?" (2) An important distinction between growth and level of earnings. (3) Forward earnings continue to make record highs. (4) Earnings giveth, while P/Es taketh away. (5) The earnings trend is our friend. (6) 2019 earnings at $166 per share a solid bet ... now go figure year-end 2018 P/E to get S&P 500 price target. (7) Comparing dividend yield and interest rates to time recessions and bear markets doesn't work very well. (8) The second-longest expansion could be the longest next July. (9) Watching out for the next financial crisis and recession.

Strategy I: Earnings Heading Higher. The S&P 500 continues to be choppy around last year's closing price (*Fig. 1*). That seems to trouble some market commentators, who note that the market rose 19.4% last year without any significant volatility (*Fig. 2*). They worry that the action so far this year may signal a major market top. They say that Trump's corporate tax cut at the end of last year was fully discounted during 2017 through January's record high this year. Then investors decided to sell on the news making that top, figuring that the earnings news can't possibly get any better.

Joe and I agree that the growth rate for earnings this year is as good as it gets, especially this late in an economic expansion. It's not unusual to see double-digit earnings growth rates during economic recoveries, but then earnings growth usually settles near the historical trend around 7% as the expansion matures. That's probably where growth will settle during 2019 following the spectacular boost provided by Trump's corporate tax cut. In other words, earnings should continue to rise into record-high territory next year and beyond, but at just a single-digit rate of rise, provided that the economy continues to grow. Consider the following:

(1) *Forward earnings.* The time-weighted average of analysts' consensus earnings expectations for this year and next year rose to record highs during the final week of April for the S&P 500/400/600 (*Fig. 3*). Since the week of December 15, when the Tax Cuts and Jobs Act was enacted, they are up 12.5%, 12.5%, and 18.6%, respectively.

(2) *Valuation.* Since their most recent peaks during January, the forward P/Es of the three market-cap indexes dropped through yesterday's close, as follow: S&P 500 down 13% from 18.6 to 16.2, S&P 400 down 13% from 18.6 to 16.2, and S&P 600 down 20% from 20.1 to 17.2 (*Fig. 4*).

(3) *Blue Angels.* Putting all of the above together in our Blue Angels framework shows that what Trump gaveth in earnings, he tooketh away with his protectionist threats (*Fig. 5*). Of course, the Fed's ongoing normalization of monetary policy also weighed on valuations, as the bond yield reached 3.00% last week.

(4) *Earnings trend.* Data through the April 26 week show that industry analysts are currently expecting S&P 500 operating earnings growth to increase from 11.2% last year to 19.8% this year (*Fig. 6*). Next year, they are projecting that growth will slow to 10.3%. Collectively, analysts tend to be too optimistic.

It's more likely that earnings will be back growing along their long-term trend line. Since 1979, S&P 500 forward earnings has risen along a 7% trendline (*Fig. 7*). It should be back on that trend later this year.

(5) *YRI projections.* Joe and I are forecasting that S&P 500 earnings will rise 17.4% this year to \$155.00 and 7.1% next year to \$166.00 (*Fig. 8*). That last number for earnings is the key one for projecting where the S&P 500 is likely to be by the end of this year. It should be the forward earnings estimate that will be discounted by the market, assuming our estimate is in the right neighborhood.

The S&P 500 closed at 2673.61 last year. Using our estimate for 2019 earnings, here is where it should be assuming forward P/Es of 14, 16, 18, and 20:

2324 (down 13.1%)
2656 (down 0.7%)
2988 (up 11.8%)
3320 (up 24.2%)

Our S&P 500 forecast remains at 3100, which requires a P/E of 18.7. Our earnings outlook is relatively uncontroversial. That means we will be quibbling about the P/E for the rest of the year, which, as noted above, is currently down to 16.2. So it has a ways to go to make our forecast come true. The fears of an "earnings peak" make no sense to us. Hopefully, our forecast for the P/E isn't nonsense.

Strategy II: The Dividend Yield Scare. Contributing to the stock market's agita so far this year has been the prospect that the 10-year US Treasury bond yield may be on the verge of rising above 3.00%, a level that for some reason is perceived as particularly dangerous for stocks. We suppose that's mostly because a few widely respected market gurus have been warning that the risks of a bear market in stocks increase above this totally subjective threshold level. Perversely, at the same time, there has been some consternation over the fact that the yield curve has been flattening. That implies that the bond yield hasn't increased fast enough relative to the federal funds rate and relative to the two-year Treasury note yield! So what are we supposed to be rooting for?

Complicating matters some more are that as the Fed has hiked the federal funds rate, short-term Treasury bill and note yields have risen to match or even exceed the S&P 500's dividend yield. A few market commentators deem that this development also increases the odds of an imminent bear market. So we have nothing to fear but that interest rates will continue to rise above the dividend yield and that short-term rates will rise faster than long-term rates. Consider the following:

(1) *S&P 500 yields.* Joe and I like to look at the S&P 500 dividend yield along with the S&P 500 earnings yield (*Fig. 9*). The latter is derived from the former. On average over time, half of earnings tends to be paid out as dividends (*Fig. 10*). During Q1-2018, the dividend yield was 1.89%, while the earnings yield during Q4-2017 was 4.78% (for the latter, Q1 data aren't yet available).

(2) *Treasury bill rates.* The one-year US Treasury note yield rose to 2.06% during March and above the S&P 500 dividend yield for the first time since June 2008 (*Fig. 11*). We are hard pressed to see a predictable pattern showing that the spread between the one-year and the dividend yield can be useful in calling bear markets. They tend to occur when interest rates rise high enough to cause a recession. Simply crossing above the dividend yield isn't a sure-fire signal of an impending recession and bear market.

(3) *Treasury bond yields.* Comparing the 10-year Treasury bond yield to the dividend yield makes even less sense as a bear market indicator. This yield is usually compared to the earnings yield, since the total return of stocks tends to be driven by overall earnings (*Fig. 12*). Whether it makes sense for

investors to compare just the dividend yield to the bond yield is a debatable issue.

US GDP: Ambling into the Record Books? Real GDP rose 2.3% (saar) during Q1-2018. That was the best Q1 growth rate since 2015 (*Fig. 13*). That's saying a lot since Q1 has had a residual seasonal adjustment problem fairly steadily since 2010. On a y/y basis, real GDP rose 2.9%.

Not widely recognized is that real GDP excluding total government spending (on goods and services, not on entitlements) had been growing around 3.0% y/y consistently from mid-2010 through mid-2015 (*Fig. 14*). It fell below 2.0% during 2016 when a recession rolled into the energy sector. During Q1, it was back over 3.0% for the first time since Q2-2015.

As we observed last Tuesday, this month, the current expansion just became the second longest expansion of the previous eight since 1959. It will be the longest of them all in July 2019. In the past, the ends of expansions were marked by financial crises, which caused credit crunches, thus triggering recessions (*Fig. 15*). We don't see that as a plausible risk anytime soon.

CALENDARS

US. Wed: ADP Employment 193k, MBA Mortgage Applications, EIA Petroleum Status Report, Treasury Refunding Announcement, FOMC Decision 1.625% (1.50%-175%). **Thurs:** Merchandise Trade Balance -$49.9b, Factory Orders 1.3%, ISM & IHS Markit NM-PMIs 58.4/54.4, Productivity & Unit Labor Costs 0.9%/3.0%, Jobless Claims 224k, Challenger Job-Cut Report, Weekly Consumer Comfort Index, EIA Natural Gas Report. (*Wall Street Journal* estimates)

Global. Wed: Eurozone GDP 0.4%q/q/2.5%y/y, Eurozone Unemployment Rate 8.5%, Eurozone, Germany, France, and Italy M-PMIs 56.0/58.1/53.4/54.5, Italy GDP 0.3%q/q/1.5%y/y, Japan Consumer Confidence 44.5. **Thurs:** Eurozone Headline & Core CPI 1.3%/0.9% y/y, UK Composite & Nonmanufacturing PMIs 53.7/53.5. (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—posted its first gain since reaching a new record high the week of March 10. Our WLI edged up 0.5% during the week of April 21 after sliding the prior five weeks by a total of 1.9%. It is only 1.4% below its record high. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). Our BBB rebounded 1.0%, after contracting 3.6% the previous five weeks—as jobless claims, one of the components of our BBB, fell for the first time in six weeks. Claims sank to 229,250 (4-wa) after climbing from 222.750 (lowest since 1973) to 231,500 the prior five weeks. Meanwhile, the CRB raw industrial spot price index, another BBB component, remains in a volatile flat trend around recent highs, moving toward the bottom of the range in recent sessions. The WCCI took a small step back after reaching a new cyclical high in mid-April.

S&P 500 Q1 Earnings Season Monitor (*link*): With nearly 61% of S&P 500 companies finished reporting earnings and revenues for Q1-2018, nearly all metrics are stronger compared to the same point during the Q4 season. If the current readings for revenue and earnings surprise and their y/y growth metrics keep up, Q1 will mark the best quarterly reporting season in seven years. Of the 303 companies in the S&P 500 that have reported, 81% exceeded industry analysts' earnings estimates by an average of 7.9%; they have averaged a y/y earnings gain of 25.7%. At the same point during the Q4-2017 reporting period, a lower percentage of companies (78%) in the S&P 500 had beaten consensus earnings estimates by a lower 4.6%, and earnings were up a lower 16.4% y/y. On the revenue side, 75% beat sales estimates so far, with results coming in 1.5% above forecast and 9.7% higher than a year earlier. At this point in the Q4 season, a higher 80% had exceeded revenue forecasts by a lower 1.2%, and sales rose a lower 9.6% y/y. Q1 earnings results are higher y/y for 88% of companies vs a lower 81% at the same point in Q4, and Q1 revenues are higher y/y for 91% vs 89% a quarter ago. These figures will continue to change 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.

US ECONOMIC INDICATORS

Auto Sales (*link*): Motor vehicle sales in April gave back March gains, falling back down to February's 17.1mu (saar), after rebounding to 17.5mu during March. Sales reached a 12-year high of 18.6mu last September—boosted by consumers' replacement of flood-damaged vehicles in areas hit by the hurricanes. Domestic car sales remains the weakest segment of the market, sinking to 3.9mu (saar) last month—the lowest reading since November 2010. Light-truck sales dipped from 9.6mu to 9.3mu (saar)—not too far from September's 9.7mu peak, which was the strongest showing since the summer of 2005. Meanwhile, sales of imports climbed to 4.0mu (saar)—its strongest pace since summer 2009.

Construction Spending (*link*): Construction spending in March posted its biggest decline in nearly a year, though spending for both February and January were revised higher. Total spending sank 1.7% last month after upwardly revised gains of 0.9% and 1.7% the prior two months. Private construction spending slipped 2.1% in March after a four-month surge of 6.4% to a new record high, while public construction spending was unchanged after jumping 11.0% the previous seven months. Residential (-3.5%) construction drove private construction spending lower in March, led by big declines in home-improvement (-8.0) and multi-family (-2.7) spending; single-family (-0.4) construction was little changed, following a nine-month spurt of 9.4% to a new cyclical high. Private nonresidential investment edged down 0.4% after a 1.2% gain and a 0.5% loss the prior two months. It was 2.2% above year-ago levels, while residential investment was 5.3% above.

Manufacturing PMIs (*link*): Manufacturing activity in April accelerated at its fastest rate in over three and a half years according to IHS Markit, while ISM's measure slowed for the second month since reaching a near 14-year high in February. The ISM M-PMI slipped to 57.3 last month, a robust reading although down from 59.3 in March and 60.8 in February. All the components of the overall index slowed last month, except for supplier deliveries (61.1 from 60.6), which held above 60.0 for the third month. Meanwhile, both the new orders (61.2 from 61.9) and production (57.2 from 61.0) indexes moved down again in April, though the former remained above 60.0 for the 11th consecutive month, while the latter fell below 60.0 for the first time since last April. The new export orders index (57.7 from 58.7) slipped further below 60.0 after moving above that threshold in February for the first time since April 2011. The employment (54.2 from 57.3) measure fell back down to January's hiring rate, which was the slowest since May of last year, while inventories (52.9 from 55.5) accumulated at their slowest pace since the start of the year; inventories had contracted the last three months of 2017. The ISM price index climbed to 79.3—the highest since April 2011—as 94.4% of industries reported paying higher prices. IHS Markit's M-PMI climbed for the second month, from 55.3 in February to 56.5 in April, the fastest growth since September 2014—well above the series trend. Last month's acceleration was driven by stronger expansions in both new orders and production; better orders data haven't been seen for three and a half years. New export sales continued to increase at a modest pace, similar to that seen in March. "Warning lights are being flashed in relation to inflation," according to the report, with factories reporting the strongest acceleration in prices in nearly seven years. Suppliers are hiking prices in response to surging demand—with tariffs and higher oil prices also exerting upward pressure on costs.

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