MORNING BRIEFING
May 3, 2018

Winds of Change

See the pdf and the collection of the individual charts linked below.

(1) Turbulent stock market has brought P/Es back to reasonable levels. (2) S&P 500 forward P/E now stands at 20-year historical average. (3) Certain sectors look particularly attractive. (4) Telecom faces volatile business environment, disrupted by consumer choice. (5) Telcos' response: M&A. (6) Disruptor extraordinaire Jeff Bezos casts his sights beyond Earth.

Strategy: Multiples on the Move. The past three months of market volatility have not been comfortable to live through. However, the passage of time combined with continued strong earnings growth has left the S&P 500 with a much-improved valuation.

The S&P 500's forward P/E, which stood at 18.6 in late January, has declined to 16.3 (*Fig. 1*). That's a pretty speedy drop, and it places the index's forward P/E dead on its 20-year average of 16.3. Let's take a look at which sectors have contributed the most and the least to this sudden return to reasonableness:

(1) *Energy earnings up, P/E down*. The largest drop in forward P/Es comes from the Energy sector, which back in April 2016 saw its forward P/E climb to 57.5 when oil prices were low and earnings were scarce. Today, the situation is much improved, with oil approaching $70 a barrel and energy stocks up 8.8% y/y through Tuesday's close. The enhanced earnings picture has helped the sector's forward P/E drop to 19.8 despite the rising stock prices (*Fig. 2*).

(2) *Suffering safety stocks*. The Telecom Services and Consumer Staples sectors experienced the next largest drops in forward P/Es over the last two years. Both sectors were deemed to be "safe," and both offered dividend yields that many investors considered bond alternatives. But as growth stocks took off and, more recently, as interest rates backed up, investors have fled these sectors.

The Telecom Services forward P/E has fallen from 14.7 in July 2016 to a recent 10.7. If you take a longer look at history, the drop in the forward P/E is even more dramatic, as the multiple stood at 19.6 in 2012 (*Fig. 3*). The sector's stock price index has moved sideways as earnings have climbed over the past five years, most recently helped by a lower tax rate (*Fig. 4* and *Fig. 5*). We take a deeper look at some of the sector's operational headwinds below.

The Consumer Staples sector has also come under pressure as competition in the grocery aisles has heated up. As we've discussed in the past, Amazon's acquisition of Whole Foods and the expansion of German discount grocers Aldi and Lidl in America have put pressure on food companies to keep a lid on prices, even though many are experiencing rising costs.

The sector's earnings growth has slowed from 14%-15% in the late 1990s to under 10% today. And its forward P/E has dropped from 21.1 in July 2016 to a recent 16.3 (*Fig. 6*).

(3) *Rare expanding P/Es*. Four sectors have seen forward earnings multiples improve over the past two years, even after they've come down sharply from earlier this year. The Consumer Discretionary sector's forward P/E has climbed more than any other sector's over the past two years; 8.4% to 19.5. While down from a recent peak of 21.9 in January, the sector's P/E also makes it the most expensive of the S&P 500's 11 sectors except for Real Estate (*Fig. 7*). The Consumer Discretionary sector's multiple has been inflated by members that are more tech-like than shopping-oriented, i.e., Amazon and Netflix.

Not far behind is the 7.9% increase over the past two years in the Tech sector's forward P/E, which now stands at 17.3 (*Fig. 8*). Industrials also has enjoyed a rising forward P/E over the last two years, climbing 19% to 16.4 (*Fig. 9*). However, it's down from a recent peak of 19.5 in January. Likewise, Financials ex-Real Estate's forward P/E has risen over the last two years. It's up from 10.1 in February 2016 to 12.8 now, but down from 14.9 in December 2017 (*Fig. 10*).

(4) *Frail Heath Care.* Perhaps the most intriguingly valued sector is Health Care, which has a forward P/E of 15.1. The sector's multiple has held in a tight range of 14 to 18 since 2014 (*Fig. 11*). Health Care is one of the few sectors with a greater earnings contribution to the S&P 500 than market-capitalization share of the index (*Fig. 12*).

Looking at other sectors with shrinking forward P/Es over the past two years, Utilities' 16.1 forward P/E as of April 26 compares to 18.8 two years ago. Likewise, the Materials sector's forward P/E has dropped to 15.9 from 17.7.

(5) *A helping hand from earnings.* As we mentioned above, there have been two driving forces behind the decline in the S&P 500's P/E. First, stock prices have dropped from January's peak. And, as we discussed in yesterday's *Morning Briefing*, earnings estimates for 2018 and 2019 have risen nicely as companies and analysts have come to appreciate the positive impact that the Trump administration's tax cuts will have on corporate profits (*Fig. 13*).

Here's the derby for the percentage change in 2018 consensus expected earnings since the passage of the TCJA: Energy (22.7%), Telecom Services (15.9), Financials (12.0), Industrials (10.6), S&P 500 (8.7), Consumer Discretionary (7.7), Materials (7.5), Tech (6.6), Health Care (5.3), Consumer Staples (4.3), Utilities (1.9), and Real Estate (-3.4).

Telecom: Busy Signal. There's no doubt that consumers are addicted to the Internet and video programing. Netflix added 7.4 million streaming subscribers in Q1. YouTube's PewDiePie "channel" has 61.3 million subscribers. And Amazon's Prime recently divulged that more than 100 million people have signed up for its service.

But just as customers are constantly tuned in to the Internet and video programs, they're also figuring out how to access that content for less by cutting cords and trading down to less expensive services. This has left the traditional communications providers jumping into acquisitions, perhaps in hopes that a good offense is sometimes the best defense. I asked Jackie to have a closer look at what has investors hanging up on the sector:

(1) *Customers pinching pennies*. Across the telecom and cable industry, consumers are opting for lower-cost services to access their media. When AT&T reported earnings last week, it noted that its lower-cost DirecTV Now online streaming service added 312,000 subscribers in Q1, but it lost 188,000 DirecTV satellite-TV customers, which pay more for their TV service.

Likewise, the company added 192,000 prepaid wireless phone customers, but it lost 22,000 postpaid customers in the quarter. Prepaid customers "buy phones loaded with data and call minutes ahead of time. Those accounts also tend to generate less revenue than [postpaid] customers on monthly plans," reported a 4/25 *WSJ* article.

The same tale of woe came from Charter Communications, which lost 122,000 video customers in Q1 but added 331,000 high-speed Internet customers. Comcast lost 96,000 cable TV subscribers in Q1, and Verizon Communications lost 22,000 Fios video customers.

(2) *Is bigger better?* Merger mania has taken over telecoms as the industry looks for ways to survive the disruption. AT&T is hoping a judge approves its $85 billion planned acquisition of Time Warner over the protests of the Justice Department.

Meanwhile, T-Mobile US announced last week its plan to acquire Sprint for $26 billion. The combined company would have roughly 100 million wireless subscribers, bulking it up to compete with AT&T, which has 93 million wireless customers, and Verizon, which has 116 million wireless subs. This deal could also face opposition from regulators looking to protect competition in the industry.

Comcast announced a $31 billion bid for European pay-TV company Sky PLC, topping an existing offer from 21 Century Fox, which already has a 39% stake in Sky. Disney is also in M&A mode, having offered to buy Fox's entertainment assets for $52.4 billion.

(3) *The numbers*. AT&T and Verizon compose the Integrated Telecom Services stock price index, which is down 12.2% ytd and down 7.1% y/y (*Fig. 14*). Likewise, the Cable & Satellite stock price index (CHTR, CMCSA, and DISH) has dropped 19.5% ytd and 19.7% y/y (*Fig. 15*).

The Telecom Services industry is expected to grow earnings by 14.2% this year, helped by the tax cuts, and 2.4% in 2019. Its forward P/E is only 10.7. Expectations for the Cable & Satellite industry are a bit brighter, with earnings projected to increase by 22.3% in 2018 and 13.6% next year. Its forward P/E is 16.6.

Energy: Bezos in Space. When the richest person in the world speaks, it's often wise to listen. We were richly rewarded for listening to a recent interview of Jeff Bezos, who was receiving the Axel Springer Award from Mathias Dopfner, the CEO of Business Insider's parent company.

During the discussion, he shared interesting nuggets about his childhood, including time working on his grandparents' ranch in South Texas, his love of computers as a kid, and the early days of Amazon, kneeling on the ground boxing up books to be mailed out to customers.

What caught our attention, however, was the discussion surrounding Blue Origin, the space company Bezos funds by selling $1 billion a year of his Amazon stock. He described his efforts at Blue Origin as "the most important work" he's doing.

Bezos is worried about the earth's energy supply. If humans' need for energy increases by 2%-3% each year, in a few 100 years, he fears there will be an energy crisis. There won't be enough room on Earth for the solar panels necessary to meet our energy needs.

His answer to this problem: space. The solar system could support a trillion humans and has unlimited energy resources from solar power.

Bezos' immediate goal is to create reusable space vehicles to reduce the cost of sending people into space. He expects Blue Origin will be sending people into space by late this year or early 2019. But eventually, Bezos envisions Earth as a place for living and light industry and the universe as a place where heavy industry will occur.

"Sometime in the next few hundred years there will be a big inversion where we will realize that we shouldn't be doing heavy industry on Earth for two reasons: One, it's very polluting; and two, we don't have access to enough energy here do it. It just won't be practical," he explained in a 3/9/16 *Washington Post* article.

Elon Musk also has his sights on space, but he's doing so because history suggests a doomsday event will happen and humans should have a backup planet on which to set up shop. His bet: Mars will provide the best home, according to a 9/27/16 article in *Wired*. Bezos hasn't called dibs on any specific planet or moon, but we have no doubt Amazon's CEO already has an idea of where Earth 2.0 should be established.

CALENDARS

US. 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. **Fri:** Total, Private, and Manufacturing Payroll Employment 190k/190k/19k, Unemployment Rate & Participation Rate 4.0%/62.9%, Average Hourly Earnings 0.2%m/m/2.7%y/y, Average Workweek 34.5hrs, Baker-Hughes Rig Count, Dudley, Quarles, Bostic, George. (*Wall Street Journal* estimates)

Global. Thurs: Eurozone Headline & Core CPI 1.3%/0.9% y/y, UK Composite & Nonmanufacturing PMIs 53.7/53.5. **Fri:** Eurozone, Germany, France, and Italy Composite PMIs 55.2/55.3/56.9/53.7, Eurozone, Germany, France, and Italy NM-PMIs 55.0/54.1/57.4/53.0, China Caixin NM-PMI 52.3, RBA Statement on Monetary Policy. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): Our Bull/Bear Ratio (BBR) remained below 3.00 this week for the sixth week after 26 weeks above. The BBR fell for the sixth time in seven weeks, dropping to 2.10 this week—the lowest since November 2016—from a recent high of 3.50 in mid-March. Most of the recent movement has been between the bullish and correction camps. Bullish sentiment fell to 43.6% this week after rising the prior two weeks from 42.2% to 48.0%, while the correction count climbed to 35.6% this week after falling from 39.2% to 32.4% the previous two weeks. Bearish sentiment climbed from 19.6% to 20.8% this week, the most bears since November, though movements have been relatively subdued. The AAII Ratio climbed for the second week to 59.1% last week, after sliding the previous four weeks from 63.3% to 37.9%. Bearish sentiment fell for the second week from 42.8% to 25.6% over the period, while bullish sentiment slipped to 36.9% last week after rising from 26.1% to 37.8% the previous week.

S&P 500 TCJA Earnings Leaders & Laggards (*link*): The 2018 earnings forecast for the S&P 500 has surged 8.7% in the 19 weeks since the TCJA was signed into law on December 22. This outstanding performance has no comparison over the years since consensus earnings forecasts were first derived in 1978. The change in the 2018 forecast improved from 8.0% a week earlier as analysts began to incorporate the outstanding Q1 results into their models. The top sector gainers since the TCJA was passed: Energy (27.7%), Telecom (15.9), Financials (12.0), and Industrials (10.6). Real Estate is the sole decliner, with a drop of 3.4%; also underperforming the S&P 500 are Utilities (1.9), Consumer Staples (4.3), Health Care (5.3), Tech (6.6), Materials (7.5), and Consumer Discretionary (7.7). Higher oil prices have contributed heavily to the improvement in Energy's 2018 earnings forecast.

S&P 500 Earnings, Revenues & Valuation (*link*): With analysts adjusting their models following Q1 results, S&P 500 consensus forward revenues, earnings, and margins rose to record highs last week. The forward profit margin forecast edged up 0.1ppt to 12.1%, which is up from 11.1% prior to the passage of the TCJA in December and a 24-month low of 10.4% in March 2016. Forward revenue growth rose to 6.0% from 5.9%, 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 improved 0.2ppt w/w to 15.9%. That's down from 16.9% in February, which was the highest since October 2010, but it's up 4.8ppts from 11.1% prior to the passage of the TCJA, and up 11.9ppts from the cyclical low of 4.8% in February 2016. Turning to the consensus expectations for 2018, the revenue growth forecast improved w/w to 7.2% from 7.0%; and earnings growth rose to 20.5% from 19.8%. Looking at last week's results among the 11 sectors, five had a w/w improvement in their forward revenue growth forecast and nine had forward earnings growth improve. Energy's contribution to forward growth peaked at the start of 2017. The S&P 500 ex-Energy's forward growth was rose 0.1ppt to 5.6% for revenues and 0.2ppt to 14.6% for earnings. The S&P 500 ex-Energy forward profit margin rose 0.1ppt to a record high of 12.7%, which is up from 11.7% before the TCJA. The S&P 500's forward P/E dropped to 16.3 from 16.8, 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 of 1.97 was down from 2.02, and compares to late January's record high of 2.16.

S&P 500 Sectors Earnings, Revenues & Valuation (*link*): Consensus forward revenue forecasts rose w/w for seven of the 11 sectors, and forward earnings forecasts rose for all but Materials. These six had both measures improve w/w: Consumer Discretionary, Energy, Financials, Health Care, Industrials, and Tech. 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 its 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, and most fell w/w with the exception of Financials and Telecom. 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 1.29 compares to a record high of 1.56 in May 2016, and its P/E of 19.8 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 forward earnings includes gains from property sales and typically improves as the year progresses. Indeed, Real Estate posted a 0.2% gain w/w in their forward profit margin, followed by 0.1ppt increases for these five sectors: Energy, Financials, Industrials, Tech, and Telecom. Materials was the sole decliner, with a drop of 0.1ppt. Here's how the sectors rank based on their current forward profit margin forecasts: Information Technology (22.5%), Financials (18.5), Real Estate (16.5), Telecom (13.3), Utilities (12.2), S&P 500 (12.1), Materials (11.4), Health Care (11.2), Industrials (10.2), Consumer Discretionary (8.1), Consumer Staples (7.1), and Energy (6.6).

S&P 500 Q1 Earnings Season Monitor (*link*): With nearly 69% 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 343 companies in the S&P 500 that have reported, 81% exceeded industry analysts' earnings estimates by an average of 7.4%; they have averaged a y/y earnings gain of 25.4%. 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 9.5% 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 tad higher 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 90% vs

89% a quarter ago. These figures will continue to change as more Q1-2018 results are reported in the coming weeks. With the season two-thirds complete, 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

ADP Employment (*link*): "The labor market continues to maintain a steady pace of strong job growth with little sign of a slowdown," said Ahu Yildirmaz, co-head of the ADP Research Institute. "However, as the labor pool tightens it will become increasingly difficult for employers to find skilled talent." In April, private industries added 204,000 to payrolls—the sixth straight month of increases of 200,000 or more—following downward revisions to both March (to 228,000 from 241,000) and February (241,000 from 246,000), for a net loss of 18,000. Service-providing industries (160,000) accounted for over three-quarter's of April's gain, though goods-producing industries (44,000) registered another strong performance. Construction (27,000) led the strength in goods-producing hiring, although manufacturers (10,000) continued to add to payrolls at a solid rate. Over the past 16 months, construction and manufacturing jobs have increased 350,000 and 252,000, respectively. Within service-providing industries, the increase was broad based, with professional & business services (58,000), leisure & hospitality (36,000), and health care & social assistance (35,000) leading the pack. By company size, medium-sized companies remained at the top of the leader board, adding 88,000 jobs—60,000 service-providing and 28,000 goods-producing. Small companies moved out of the bottom slot, adding 62,000 to payrolls—53,000 service-providing and 10,000 goods-producing—while large companies (54,000) fell to the bottom slot, with a mix of 48,000 service-providing jobs and 6,000 goods-producing ones. Here's the tally by company size over the past 12 months: medium (972,000), large (795,000), and small (570,000)—for a total gain of 2.3 million.

GLOBAL ECONOMIC INDICATORS

Global Manufacturing PMIs (*link*): Global manufacturing activity posted a mild improvement in April, as orders and production growth both ticked higher, supporting steady job creation. However, the upturn is subdued compared to the start of the year, in part reflecting a recent slowing of growth in new export orders. April's JP Morgan M-PMI edged up to 53.5 after falling from a near-seven-year high of 54.5 in December to 53.3 in March. Developed nations (to 55.1 from 54.9) continued to record much stronger growth than emerging markets (unchanged at 51.3), though both have slowed since late last year. Among the larger industrial nations, M-PMIs show the US (56.5 from 55.6) manufacturing sector grew at its fastest pace in 3.5 years, while growth in the Eurozone (56.2 to 56.6) was the slowest in 13 months, though still robust. Within the Eurozone, M-PMIs for five of the eight nations covered registered slower rates of growth than in March—the Netherlands (60.7, 6-month low), Germany (58.1, 9-month low), Spain (54.4, 7-month low), Italy (53.5, 15-month low), and Greece (52.9, 5-month low). Ireland (55.2, 2-month high) and France (53.8, 2-month high) both showed slightly faster growth last month, while Austria (58.0) matched March's rate. The top three performers remained the Netherlands, Germany, and Austria. Aside from the US and the Eurozone, Japan's M-PMI (53.8 from 53.1) showed slightly faster growth, while the UK's (53.9 from 54.9) was the weakest in 17 months. Among the emerging economies, manufacturing sectors in India (51.6 from 51.0) and China (51.1 from 51.0) showed a slight improvement in growth, while Brazil's (52.3 from 53.4) slowed to a three-month low.

Japan Consumer Confidence (*link*): Consumer confidence in April was the lowest in eight months, though was not far from the four-year high of 44.6 posted from November through January. All measures continued to retreat last month—overall livelihood (to 41.5 from 42.0), income growth (42.3

from 42.6), employment (47.9 from 49.1), and willingness to buy durable goods (42.7 from 43.3)—though remained at relatively high levels.

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