



MORNING BRIEFING

May 14, 2018

What Are They Smoking?

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

(1) High on life, revenues, and earnings. (2) Revenues are strongest among cyclical sectors. (3) As latest earnings season unfolds, Q1 beat expectations, yet remaining quarters remain unchanged. (4) Analysts now predicting earnings will grow 21% this year and 10% next year. (5) Profit margins at record highs. (6) Margins could get squeezed by more outlays on labor and capital. (7) Our earnings estimates are upbeat, but not as much as analysts' consensus. (8) Alternative earnings scenarios are mostly bullish for stock prices.

Strategy I: Revenues Estimates Are Hot. The industry analysts covering the S&P 500 companies are high on life or something else. Their consensus expectation for the composite's 2018 revenues per share has increased to a new record high at the end of April, up 3.4% since the first week of September 2017 ([Fig. 1](#)). Over the same period, their estimate for 2019 revenues has risen by 3.2%. They now expect that revenues will be up 7.4% this year and 4.7% next year ([Fig. 2](#)). Joe and I doubt that Trump's tax cuts at the end of last year converted analysts into supply-side believers. More likely is that companies are telling analysts that global economic growth is improving.

Let's dive into revenues expectations for the individual S&P 500 sectors to see what's been driving the aggregate expectation skyward ([Fig. 3](#)).

(1) *2018 revenues.* We can see that much of the strength in revenues is spread across the cyclical sectors. Focusing on the percentage increases in 2018 expected revenues per share since the first week of September, here's the performance derby: Energy (11.7%), Health Care (10.0), Tech (4.5), Materials (4.3), Real Estate (3.7), Industrials (3.6), S&P 500 (3.4), Consumer Discretionary (3.0), Financials (2.8), Telecom (0.0), Utilities (-4.2), and Consumer Staples (-7.9).

(2) *2019 revenues.* A similar exercise for the percentage increases in 2019 expectations shows the following: Health Care (9.8%), Energy (6.5), Tech (6.0), Materials (4.3), Industrials (4.1), Real Estate (3.8), Consumer Discretionary (3.3), S&P 500 (3.2), Financials (3.1), Telecom (0.6), Utilities (-3.6), and Consumer Staples (-8.0).

(3) *2018/2017 revenues growth.* Here is the latest derby for the consensus projected revenues growth rates in 2018 over 2017: Energy (16.6%), Tech (11.8), Real Estate (9.0), Materials (8.9), Consumer Discretionary (7.6), S&P 500 (7.4), Industrials (7.1), Health Care (5.8), Consumer Staples (4.3), Financials (4.0), Telecom (1.3), and Utilities (1.1).

(4) *2019/2018 revenues growth.* Here is the latest derby for the consensus projected revenues growth rates in 2019 over 2018: Tech (7.2%), Consumer Discretionary (5.9), Health Care (5.3), Industrials (4.8), S&P 500 (4.7), Financials (4.6), Consumer Staples (3.8), Utilities (3.0), Materials (2.5), Energy (1.5), and Telecom (0.6).

Strategy II: Earnings Estimates Are Going Vertical. Consensus expectations for the S&P 500 companies' 2018 earnings per share soared by \$11.05 from the week of December 14, 2017—which was just prior to the enactment of Trump's tax cuts—through the week of February 15, 2018 ([Fig. 4](#)).

That period roughly aligned with the earnings reporting season for Q4-2017, before the tax cuts were actually implemented—i.e., nothing about those results would have reflected beneficial tax reform impacts. However, analysts gleaned enough guidance from the giddiness of corporate managements on Q4 earnings calls to jack up their 2018 estimates dramatically. Now that the Q1-2018 earnings season is well underway, estimates are ratcheting to new highs.

Let's have a closer look at what is going on with consensus earnings expectations:

(1) *Q1-2018 earnings flying high.* During the previous earnings season (for Q4-2017), earnings estimates for all four quarters of 2018 rose almost in lockstep ([Fig. 5](#)). During the current earnings season, the Q1-2018 estimate has been revised higher, while expectations for the remaining three quarters of the year have been remarkably flat.

Frankly, we are puzzled this is happening. It suggests that while Q1-2018 results are surprising analysts to the upside, corporations are guiding analysts to be more cautious about how much better they can perform over the rest of this year. In any case, the blend of actual and estimated Q1 earnings is up \$1.76 since the start of the current earnings season, and up \$3.72 since Trump's tax cut was enacted. That's YUGE!

(2) *2018 and 2019 estimates edge up to record highs.* As a result, the estimate for all of 2018 edged up to a record high of \$160.14 during the week of May 3 ([Fig. 6](#)). By the way, the estimate for 2019 also edged up, to \$175.48.

(3) *2018 growth rate rocketing.* Just before Trump's tax cut, industry analysts were projecting earnings growth of 11.2% this year ([Fig. 7](#)). Now they are projecting 21.3%! On the other hand, their earnings growth estimate for 2019 edged down to 9.7%.

(4) *Us vs them.* We would like to try some of whatever the analysts are smoking. You can compare our earnings forecasts to their consensus estimates on a weekly basis in [YRI S&P 500 Earnings Forecast](#) on our website. We say "tomato." They say "tomahto."

Our estimate for 2018 is \$155.00 (up 17.4% y/y). The analysts continue to up the ante and are currently at \$160.14 (up 21.3%), as noted above. Our estimate for 2019 is \$166.00 (up 7.1%). Theirs is \$175.48 (up 9.6%).

They could be right about 2018, especially since they just boosted their Q1-2018 sights based on results reported so far during the earnings season. At the same time, they have been conservative on the remaining quarters of this year. Next year's growth estimate seems too high to us since we expect it to settle back down to the historical trend of 7%.

(5) *Profit margins exploring outer space.* Joe and I calculate the operating profit margin of the S&P 500 on a weekly basis, dividing analysts' earnings estimate by their revenues estimate for the composite's companies ([Fig. 8](#)).

Their (thusly derived) 2018 estimate for this margin jumped from 11.1% the week before Trump's tax-cutting bill was enacted late last year to 11.9% in early May. Their 2019 estimate jumped from 11.7% to 12.5% over this same period. The forward profit margin, which is the time-weighted average of the two,

rose to a record 12.2% from 11.1%.

Granted, the forward profit margin has always been higher than the actual margin based on S&P data for operating earnings ([Fig. 9](#)). But the trends have been the same.

Odds are that the profit margin windfall will be eroded if companies respond to it by spending more on labor and capital. With the unemployment rate just below 4.0%, labor costs could put some upward pressure on margins. Furthermore, Trump's tax cuts included allowing companies to depreciate their entire outlays on capital spending during the year in which they were incurred rather than over several years. That should provide a significant boost to capital spending, which would also lower the profit margin. Then again, corporations are likely to continue buying back their shares, which wouldn't affect their margins but would increase their earnings and revenues on a per-share basis.

Strategy III: Stock Market Equation. You can drive a truck between our earnings estimates and theirs. However, they both suggest that the stock market is likely to be at new record highs by the end of this year. As the year progresses, the earnings estimate for this year will be less relevant, while the estimate for 2019 will be more so. By the end of the year, the market will be discounting analysts' consensus earnings estimate for 2019, not our estimate.

However, analysts tend to be too optimistic and often lower their estimates as earnings seasons approach. So let's split the difference between our estimate and their current estimate for 2019. That would put consensus earnings for 2019 at \$170 per share by the end of this year. Now let's apply forward P/Es of 14, 16, 18, and 20 to estimate where the S&P 500 will be at year-end:

2380 (down 12.7% from Friday's close)

2720 (down 0.3%)

3060 (up 12.2%)

3400 (up 24.6%)

We pick the third scenario. Our year-end target for the S&P 500 remains 3100. In our scenario, inflation remains subdued around 2.0% for the foreseeable future. Real GDP grows between 2.5%-3.0% this year. The Fed raises the federal funds rate to 2.25%-2.50% by the end of the year. The 10-year Treasury bond yield trades between 3.00% and 3.50% over the rest of the year. Investors conclude that interest rates aren't likely to move much higher in 2019 and increasingly believe that the economic expansion might last beyond July 2019, when it will be the longest one on record. ([YRI Economic Forecasts](#) is always posted on our website.)

CALENDARS

US. Mon: Mester, Bullard. **Tues:** Retail Sales Total, Total Ex Autos, Total Ex Autos & Gas, and Control Group 0.3%/0.5%/0.4%/0.4%, Business Inventories 0.3%, Empire State Manufacturing Index 15.5, Housing Market Index 70, Treasury International Capital, Williams. (*Wall Street Journal* estimates)

Global. Mon: Global Leading Indicators, Japan Machine Tool Orders. **Tues:** Eurozone GDP 0.4%q/q/2.5%y/y, Eurozone Industrial Production 0.7%m/m/3.7%y/y, Germany GDP 0.4%q/q/.2.4%(wda)y/y, Germany ZEW Survey Current Situation & Expectations 85.2/-8.2, UK ILO Unemployment Rate (3-month) 4.2%, Japan GDP 0.0%q/q, China Retail Sales 10.0% y/y, China Industrial Production 6.4% y/y, China Fixed Assets Ex Rural (ytd) 7.4% y/y, China Jobless Rate, RBA May Meeting Minutes. (DailyFX estimates)

STRATEGY INDICATORS

Global Stock Markets Performance ([link](#)): The US MSCI index rose 2.4% last week for its best gain in nine weeks, ranking 15th out of the 49 markets in a week when 35 countries rose in US dollar terms and the AC World ex-US index gained 1.7%. That compares to the index's 0.2% decline a week earlier, which ranked 13th as eight markets rose and the AC World ex-US index dropped 0.8%. All regions rose last week, but EM Eastern Europe performed the best with a gain of 4.2%, ahead of BRIC (3.2%), EM Asia (2.6), and EMEA (2.4). The underperforming regions relative to the AC World ex-US were EM Latin America (0.6), EMU (0.8), and EAFE (1.4). Russia was the best-performing country as it surged 5.0%, followed by South Africa (4.7), China (4.2), and Sweden (4.1). Of the 29 countries that underperformed the AC World ex-US MSCI last week, Egypt fared the worst as it fell 6.3%, followed by Argentina (-5.6), Jordan (-3.6), Pakistan (-3.1), and Mexico (-1.5). On a ytd basis, the US MSCI improved w/w to a 2.2% gain from a 0.2% decline a week ago, and improved one place in the performance ranking to 21/49. The US MSCI is ahead of the AC World ex-US (-0.2) in the ytd period. Most of the regions and 28/49 countries are in positive territory ytd. BRIC has risen 2.7% ytd and now leads EMU (1.9), EM Latin America (1.5), EM Eastern Europe (1.3), EM Asia (1.2), and EAFE (0.4). EMEA (-3.1) is the only laggard relative to the AC World ex-US's performance. The best country performers ytd: Colombia (12.7), Finland (12.1), Jordan (10.9), Italy (10.0), and Peru (9.6). The worst-performing countries ytd: Argentina (-25.8), Turkey (-23.1), the Philippines (-14.1), Indonesia (-13.1), and Poland (-7.5).

S&P 1500/500/400/600 Performance ([link](#)): All three of these market-cap indexes rose last week as SmallCap performed best with a gain of 2.9%, ahead of LargeCap (2.4%) and MidCap (2.2). SmallCap is now back at a record high for the first time since late January, but MidCap remains 2.8% below its record then and LargeCap is still down 5.1%. Twenty-eight of the 33 sectors rose in the latest week, up from 18 rising a week earlier. The best performers in the latest week: MidCap Energy (5.0), SmallCap Energy (4.7), SmallCap Health Care (4.5), SmallCap Industrials (4.3), and LargeCap Energy (3.8). The biggest underperformers for the week: LargeCap Utilities (-2.3), MidCap Telecom (-1.7), MidCap Utilities (-1.2), and LargeCap Consumer Staples (-0.5). LargeCap is now up 2.0% ytd, matching the 2.0% gain for MidCap and trailing SmallCap's ytd gain of 5.4%. Eighteen sectors are now positive to date in 2018, up from just three in early February. The best-performing sectors ytd: SmallCap Health Care (23.0), MidCap Health Care (13.2), SmallCap Energy (11.8), MidCap Energy (11.4), and LargeCap Tech (10.8). The worst performers ytd: LargeCap Consumer Staples (-13.6), LargeCap Telecom (-11.7), SmallCap Real Estate (-8.8), MidCap Telecom (-5.9), and SmallCap Consumer Staples (-5.0).

S&P 500 Sectors and Industries Performance ([link](#)): Nine sectors rose last week as five outperformed the S&P 500's 2.4% gain. That compares to three rising a week earlier, when five outperformed the S&P 500's 0.2% decline. Energy was the best-performing sector with a 3.8% gain, ahead of the performances of Financials (3.6%), Tech (3.5), Industrials (3.4), and Health Care (2.5). Utilities was the biggest underperformer with a drop of 2.3%, followed by Consumer Staples (-0.5), Real Estate (0.6), Consumer Discretionary (0.8), Telecom (0.9), and Materials (1.9). Five sectors are in the plus column so far in 2018, up from three a week earlier and down from nine in early March. These three sectors are ahead of the S&P 500's 2.0% ytd gain: Tech (10.8), Consumer Discretionary (6.3), and Energy (6.0). The eight ytd underperformers: Consumer Staples (-13.6), Telecom (-11.7), Real Estate (-4.7), Utilities (-4.6), Materials (-2.7), Industrials (-1.6), Health Care (0.4), and Financials (0.9).

Commodities Performance ([link](#)): The S&P GSCI index rose 1.0% w/w as 14 of the 24 commodities we follow moved higher. That compares to a 1.3% gain in the prior week when 12/24 commodities rose. Last week's strongest performers: Lean Hogs (4.7%), Natural Gas (4.2), GasOil (4.1), Unleaded Gasoline (3.4), and Heating Oil (2.9). Last week's biggest decliners: Kansas Wheat (-6.8), Wheat (-5.2), Aluminum (-3.4), and Soybeans (-3.2). The S&P GSCI commodities index is up 9.5% ytd and near its

highest level since December 2014. The top performer so far in 2018 is Cocoa (48.3), up more than twice as much as the next-best performer, Unleaded Gasoline (21.7). Other top performers ytd: Kansas Wheat (21.2), Crude Oil (17.0), and Wheat (16.8). The biggest laggards of 2018 to date: Sugar (-26.0), Live Cattle (-14.1), Zinc (-7.4), Lead (-5.7), and Coffee (-5.4).

Assets Sorted by Spread w/ 200-dmas ([link](#)): Spreads between prices and 200-day moving averages (200-dmas) rose last week for 13/24 commodities, 9/9 global stock indexes, and 27/33 US stock indexes, compared to 14/24 commodities, 4/9 global stock indexes, and 13/33 US stock indexes rising a week earlier. Commodities' average spread fell w/w to 6.6% from 7.1%. Sixteen commodities trade above their 200-dmas, up from 15 a week earlier. Cocoa leads all commodities and all assets at 29.4% above its 200-dma, but Lean Hogs (11.3%) rose 4.6ppts w/w for the best performance among commodities. Sugar trades at 18.0% below its 200-dma, the lowest of all assets, but Kansas Wheat (12.5) tumbled 8.6ppts for the worst w/w performance among all assets. The global indexes trade at an average of 2.5% above their 200-dmas, up from 0.9% in the prior week. Seven of the nine global indexes trade above their 200-dmas, unchanged from a week earlier. Brazil (8.7) still leads the global indexes, followed by Chile (5.2) and Japan (4.7). Indonesia (-3.2) now trades at the lowest among global assets, but improved 2.6ppts for the best performance among global assets. All commodities improved w/w relative to their 200-dma, but South Korea (1.0) lagged with a gain of just 0.6ppt. The US indexes trade at an average of 3.7% above their 200-dmas, with 25 of the 33 sectors above, up from 1.9% a week earlier, when 20 sectors were above. MidCap Energy (20.5) now leads the US stock indexes as it rose 4.9ppts for the biggest gain among US stock indexes and all assets last week. LargeCap Consumer Staples (-9.4) trades the lowest among all US stock indexes, but LargeCap Utilities (-4.1) fell 2.1ppts for the worst performance among US stock indexes.

S&P 500 Technical Indicators ([link](#)): The S&P 500 price index rose 2.4% last week and improved relative to its short-term 50-dma trend line and long-term 200-dma. The index remained in a Golden Cross (50-dma higher than 200-dma) for a 106th straight week (after 17 weeks in a Death Cross), yet the index's 50-day moving average (50-dma) relative to its 200-dma dropped for a 14th week to a 24-month low of 1.9% from 2.2%, and is down from a 55-month high of 7.2% in early February. This Golden Cross reading compares to a four-year low of -4.5% in March 2016. The S&P 500's 50-dma rose for the first time in three weeks, but is down in six of the past eight weeks. It had fallen for four weeks through mid-April for its worst performance since before the 2016 election. The 200-dma continued to rise, as it has done since May 2016, but near the slowest pace since October 2011. The index rose to a 14-week high of 1.9% above its now-rising 50-dma from 0.6% below its falling 50-dma a week earlier. That compares to a 25-month low of 5.6% below its falling 50-dma near the end of March and a two-year high of 6.2% above its rising 50-dma on January 29. The S&P 500 appears to have successfully tested its 200-dma again recently, and improved to a seven-week high of 3.8% above its rising 200-dma from 1.6% above its rising 200-dma a week earlier and from 0.6% below on April 3 (the lowest reading since June 2016). That compares to a seven-year high of 13.5% on January 29 and a four-year low of -10.1% in August 2015.

S&P 500 Sectors Technical Indicators ([link](#)): Last week saw 10 of the 11 sectors improve relative to their 50-dmas and nine rise relative to their 200-dmas, while Utilities weakened relative to both measures. At the week's end, four sectors moved back above their 50-dmas: Financials, Health Care, Industrials, and Materials. That leaves just two sectors trading below their 50-dmas: Consumer Staples and Telecom. All 11 sectors had been below their 50-dmas at the end of March, which was the first time that has occurred since February 2016. Utilities was above for a seventh week, and Energy for a fifth week. The longer-term picture—i.e., relative to 200-dmas—shows 7/11 sectors trading above as Health Care, Industrials, and Materials moved above. A week earlier, just four sectors traded above their 200-dma, which matched the lowest count since January 2016. Telecom remained below its 200-dma in the latest week, where it has been in most of the weeks since April 2017. Sectors trading the

longest above their 200-dmas: Tech (above 200-dma for 97 straight weeks), Consumer Discretionary (79 straight weeks), Financials (35 weeks), and Energy (five weeks). On the other hand, Consumer Staples was below for a 12th week, Real Estate below for a 19th week, and Utilities below for a 21st week. All 11 sectors had been above both their 50-dmas and 200-dmas briefly in mid-December for the first time since July 2016. Five sectors are in a Golden Cross (50-dmas higher than 200-dmas), down from six a week earlier, as Health Care left the club for the first time since February 2017. All 11 had been in a Golden Cross in mid-January for the first time since a 26-week streak ended in October 2016. Telecom was out for a sixth week, Consumer Staples for an eighth, Real Estate for a 14th, and Utilities for a 16th. Six sectors have rising 50-dmas now, up from three a week earlier as Consumer Discretionary, Materials, and Tech joined these three sectors: Energy, Real Estate, and Utilities. That compares to all 11 sectors with falling 50-dmas during early April in the worst count since before the election in November 2016. Consumer Staples' 50-dma fell for a 14th straight week and Telecom's for a 12th week. Seven sectors have rising 200-dmas, unchanged from a week earlier. That's up from six in early February, which was the lowest since May 2017. The 200-dmas for Real Estate and Utilities fell for an 18th week, and Consumer Staples' dropped for a 12th week.

US ECONOMIC INDICATORS

CPI ([link](#)): The core CPI rate in April remained just above the Fed's target rate of 2.0% y/y for the second month. April's rate held at March's 13-month high of 2.1% y/y, after fluctuating between 1.7% and 1.8% the prior ten months. Meanwhile, the three-month rate slowed for the second month, to 1.8% (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 0.1%, after gains of 0.2% in March and February and 0.3% in January. The shelter index rose 0.3%, with other indexes mixed. The indexes for household furnishings & operations, personal care, tobacco, medical care, and apparel all rose last month, while prices for used cars & trucks, new vehicles, recreation, and air fares all fell. Headline CPI accelerated 2.5% y/y—the highest since February 2017; this rate has been mostly trending upward since falling to 1.6% in June 2017.

PPI ([link](#)): The PPI for final demand ticked up 0.1% in April, after averaging gains of 0.3% per month the first three months of this year. Prices for final demand goods were unchanged, after a 0.3% gain and a 0.1% loss the prior two months. Final demand services edged up only 0.1% after advances of 0.3% in each of the prior two months. For final demand goods, a 0.3% rise in the index less foods & energy, along with a 0.1% uptick in final demand energy, offset a 1.1% drop in final demand foods. A major factor in the April advance in prices for final demand services was the index for machinery, equipment, parts & supplies wholesaling; its increase was partially offset by declines in prices for traveler accommodation services, which exerted the biggest drag. The yearly inflation rate for the headline series slowed from 3.0% in March to 2.6% y/y in April—the lowest rate so far this year—as the rate for final demand services dropped from 2.9% to 2.4%. The goods rate continued to drift lower, from 4.2% in November to 2.9% y/y last month. Meanwhile, the core (2.3% y/y) rate slowed from March's 2.7%, which was the highest since November 2011, while the core ex trade services (2.5) eased from March's record-high 2.9%.

Import Prices ([link](#)): Import prices in April rose less than expected, and March prices were revised to show a decline. Total import prices climbed 0.3% (vs the 0.5% consensus estimate) last month, while March prices fell by a revised 0.2% rather than the initial tally's no change. Nonpetroleum prices ticked up 0.1% m/m after no change in March; these prices spiked 0.6% at the start of the year. The yearly rate for import prices in April was 3.3% y/y for the third month, up from a recent low of 1.2% last July, though remained below February 2017's five-year high of 4.7%. Prices for nonpetroleum products rose 1.7% y/y, slowing steadily from February's 2.0%, which was the highest since January 2012. Import prices for capital goods (1.1% y/y) are on an accelerating trend, while consumer goods ex autos are

showing little change over the past year. The yearly rate for petroleum prices was in double digits for the sixth month at 20.6% y/y, accelerating slightly from 17.8% in March and 17.3% in February. April's rate remains considerably below February 2017's seven-year high of 74.1%.

Consumer Sentiment ([link](#)): Consumer sentiment was unchanged in mid-May, not far from March's cyclical high. The Consumer Sentiment Index (CSI) held at 98.8 this month after slipping from March's 14-year high of 101.4 in April. The expectations component rose for the first time in three months in mid-May, to 89.5, after falling from 90.0 to 88.4 the previous two months. The present situation component declined for the second month since hitting a record high of 121.2 in March, slipping to 113.3 this month. According to the report, "Overall, the data are consistent with a growth rate of 2.7% in real personal consumption from the second half of 2018 to the first half of 2019." Expected inflation was back up at March's two-year high of 2.8%. Meanwhile, eight-in-ten consumers anticipated interest-rate hikes during the year ahead, and fewer consumers anticipated further declines in the unemployment rate—although all of the shift was toward the expectation of a stable unemployment rate rather than an increased rate.

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