



MORNING BRIEFING

May 22, 2018

Some Like It Hot

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

(1) Another relief rally following another panic attack? Probably. (2) Declaring a ceasefire before trade war has even started! (3) Chatter about shortage of liquidity is drying up. (4) Going forward, profits earned abroad will no longer be taxed in US. (5) Record year ahead for sum of buybacks and dividends. (6) Q1 S&P 500 earnings up 24%! (7) Latest economic indicators indicating no boom, no bust.

Trade: Deal Making. We may already be getting some relief on one of the major issues that has weighed on the market since early February, when President Donald Trump threatened to impose tariffs on the US's major trading partners. Melissa and I argued that his public threats were characteristic of his deal-making style. His goal isn't to shut off trade with the rest of the world but to make it fairer and more bilateral (rather than multilateral) in nature. So we are gratified that the trade negotiations already are going our way—i.e., away from a trade war. Consider the following:

(1) *China*. On Sunday, Treasury Secretary Steven Mnuchin said that the US and China had made progress as they concluded three days of intense trade negotiations in Washington late last week. The administration has suspended its plan to impose sweeping tariffs on China for now while the talks proceed. "We're putting the trade war on hold," he said on *Fox News Sunday*. The 5/20 issue of *The New York Times* [reported](#): "On Saturday, both countries released a joint statement that offered little detail about what had been agreed to, other than holding another round of discussions in China. Mr. Mnuchin said on Sunday that the countries had agreed on a 'framework' under which China would increase its purchases of American goods, while putting in place 'structural' changes to protect American technology and make it easier for American companies to compete in China."

(2) *NAFTA*. Also on Sunday, Bloomberg [reported](#) that the US is making progress in renegotiating NAFTA with Canada and Mexico. Trump frequently has threatened to quit the current agreement if a good deal can't be reached. Bloomberg quoted Mnuchin: "[W]e are focused on negotiating a good deal and we're not focused on specific deadlines," Mnuchin said on Fox. "We're still far apart but we're working every day to renegotiate this agreement."

Strategy I: Payback or More Buybacks? When stocks plunged 10.2% during the latest correction spanning the 13 days from January 26 to February 8 of this year, there was lots of chatter about liquidity drying up ([Fig. 1](#)). That development was widely attributed to the Fed's quantitative tightening, which started during October of last year ([Fig. 2](#)). You might recall that the bears (remember them?) have been predicting that the next bear market in stocks would begin once the Fed started to unwind its QE program.

If they are right about a bear market, it won't happen because of a shortage of liquidity. As discussed in the next section, Trump's corporate tax cut at the end of last year significantly boosted corporate earnings and cash flow. Just as importantly, his tax reform package required US corporations to deem earnings that they accumulated abroad repatriated. To ease the pain, a one-time mandatory transition

tax will replace the previous 35% statutory tax rate on repatriated earnings; that one-time tax has been set at 15.5% for liquid assets and 8.0% for illiquid assets and is payable over eight years.

The change effectively shifts the US from a worldwide tax system to a territorial one. That means that going forward US multinationals generally will be taxed by the US only on domestic profits and not on dividends from their foreign subsidiaries, as Bloomberg explained in a 1/25 [article](#). The concept of “repatriated earnings” will no longer exist.

Let’s see how much liquidity is parked overseas that might be used to buy back more shares:

(1) *Repatriated earnings potential.* The Fed’s quarterly [Financial Accounts of the United States](#) includes a series called “Foreign Earnings Retained Abroad.” It’s available through Q4-2017 for nonfinancial corporations. Last year, it totaled \$213.5 billion, and has been hovering around this four-quarter sum since 2010 ([Fig. 3](#)). It’s been running close to 15% of pretax profits plus foreign earnings retained abroad since mid-2012 ([Fig. 4](#)). Since 2000, the cumulative total of foreign earnings retained abroad is \$2.9 trillion. It’s up \$1.7 trillion just since 2010.

(2) *Buybacks saying “buy, buy” not “bye-bye.”* Joe and I have written that it’s hard to be bearish on stocks when \$2 trillion to \$3 trillion of cold cash may be coming back to heat up the stock market and the economy. During stocks’ selloff earlier this year, there was also some chatter about a decline in buybacks. Now there is more chatter about how a significant portion of the repatriated earnings could go into buybacks, possibly boosting them to a record high exceeding \$600 billion this year for the S&P 500 companies. That’s based on the guidance provided by company managements during their just-completed Q1-2018 earnings reporting season.

Buybacks for the S&P 500 companies totaled \$519 billion last year, down from a record high of \$589 billion during the four quarters through Q1-2016 ([Fig. 5](#)).

(3) *Dividends will also continue to fuel the bull market.* Joe and I have been observing since 2010 that the current bull market has been driven mostly by buybacks and dividends. We frequently expressed this opinion to counter the bears who claimed that stocks were on a Fed-induced sugar high.

The bears just couldn’t understand who was buying stocks. We said it was obvious: Corporations were buying back their shares and paying out record-high dividends. Lots of the dividends went back into the stock market. Over the past four quarters through Q1-2018, dividends totaled a record \$436 billion. If buybacks are on track to exceed \$600 billion this year, then total cash distributed to shareholders will easily exceed \$1.0 trillion for the first time on record.

Strategy II: Are Earnings Hot or What? Also pumping lots of additional liquidity into the corporate sector is Trump’s corporate tax cut. Joe reports that S&P 500 data are now available for Q1-2018. They show that on a per-share basis revenues jumped 9.5% y/y, reflecting solid global sales for these companies and the rebound in oil prices ([Fig. 6](#) and [Fig. 7](#)). Operating earnings per share (based on Thomson Reuters data) soared 24.0% over the same period, reflecting the strength in revenues and the tax cut. Both were at record highs last quarter. The quarterly profit margin of the composite rose to another record high of 12.0%, up from 10.9% during Q4-2017 ([Fig. 8](#)). In aggregate, S&P 500 net operating income rose 25.4% y/y to a record \$1.2 trillion during Q1 ([Fig. 9](#)).

Trump’s tax cut lifted earnings significantly to \$38.32 per share during Q1. We were close with our estimate of \$37.00. We don’t see any reason to raise our full-year estimate of \$155.00. That’s a 17.4% y/y increase. Industry analysts are expecting \$161.33, up 22.2%. As Joe and I explained last Wednesday, by year-end the stock market will be discounting the analysts’ consensus estimate for next

year, which is currently \$176.61. We are sticking with \$166.00. In any event, we believe that the earnings outlook is solid enough to drive the S&P 500 to new highs later this year. (See [YRI S&P 500 Earnings Forecast](#).)

US Economy: Hot or Not? The answer to the question just posed is that the economy is lukewarm. The next question is whether it will stay that way or will either cool off or warm up. For now, the outlook is for more of the same: no boom, no bust. Let's review what's hot and what's not:

(1) *Leading and coincident indicators.* As Debbie reported yesterday, the Index of Leading Economic Indicators continued to hit new record highs in April, advancing for the seventh consecutive month; it hasn't posted a decline in 24 months ([Fig. 10](#)). Our Weekly Leading Index jumped to yet another record high in early May. By the way, it is highly correlated with the S&P 500 stock price index as well as with S&P 500 forward earnings, which is also at a record high ([Fig. 11](#) and [Fig. 12](#)). In other words, it remains bullish.

The Index of Coincident Economic Indicators (CEI) also hit another new high in April; it has posted only one decline since January 2014 ([Fig. 13](#)). Its y/y growth rate is highly correlated with the comparable growth rate in real GDP. The CEI was up 2.2% y/y through April, continuing to fluctuate around 2.0% as it has since 2010.

(2) *Regional business surveys.* May data are available for the regional business surveys conducted by the Federal Reserve Banks of New York and Philadelphia. Both posted strong readings. The average of their new orders indexes rose to the highest since July 2004 ([Fig. 14](#)).

(3) *Economic surprise index.* On the other hand, the Citigroup Economic Surprise Index was at 12.3 on May 18, just above the May 16 reading of 11.2, which was the lowest since October 24, 2017 ([Fig. 15](#)).

CALENDARS

US. Tues: Richmond Fed Manufacturing Index 10. **Wed:** Composite, Manufacturing, and Nonmanufacturing PMI Flash Estimates 54.8/56.4/54.6, New Home Sales 677k, EIA Petroleum Status Report, FOMC Minutes. (*Wall Street Journal* estimates)

Global. Tues: None. **Wed:** Eurozone, Germany, and France C-PMI Flash Estimates 55.1/54.6/56.6, Eurozone, Germany, and France M-PMI Flash Estimates 56.0/57.9/53.7, Eurozone, Germany, and France NM-PMI Flash Estimates 54.7/53.1/57.2, UK Headline & Core CPI 2.2%/2.2% y/y, Lowe. (DailyFX estimates)

STRATEGY INDICATORS

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 42 of the past 43 weeks, MidCap's was higher last week for a 38th straight week (which now exceeds its prior record streak in mid-2002), and SmallCap's has been up in 36 of the past 39 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 a seven-year high of 21.7% y/y from 20.9%, which compares to a six-year low of -1.8% in October 2015; MidCap's rose to 23.6% from 23.4%, 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 rose to a seven-year high of 30.2% from 29.8%, which compares to a six-year low of 0.3% in December 2015. Here are the latest consensus earnings growth rates for 2018 and 2019: LargeCap 22.2% and 9.5%, MidCap 21.1% and 12.0%, and SmallCap 26.0%

and 16.2%.

S&P 500/400/600 Forward Valuation ([link](#)): Last week saw forward P/E ratios mostly edge lower for these three indexes, and put less breathing room above their recent post-election lows. LargeCap's weekly forward P/E dropped to 16.2 from 16.4 in the prior week, and 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 edged down w/w to 16.5 from 16.6, which is little improved from its 25-month low of 16.1 in early April. MidCap's P/E is down from a 15-year high of 19.2 in February 2017 and compares to 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 had been at or below LargeCap's P/E since August for the first time since 2009. SmallCap's P/E increased to 17.7 from 17.6, 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 daily forward price/sales (P/S) ratios, they were higher w/w for all three indexes at levels well below January highs: LargeCap's P/S of 2.01 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 1.01 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 less than 8% of the Q1 earnings reporting season remaining, analysts have become less busy adjusting their forecasts. The S&P 500's Q2-2018 EPS forecast gained 24 cents w/w to \$39.16. That's up 0.5% since the end of Q1, 7.8% ytd, and 8.5% since the passage of the TCJA. The \$39.16 estimate represents a forecasted pro forma earnings gain for Q2-2018 of 19.8%, up from 19.7% a week earlier. That compares to Q1-2018's blended 26.2% (which is the strongest since Q4-2010), Q4-2017's 14.8%, Q3-2017's 8.5%, Q2-2017's 12.3%, and Q1-2017's 15.3%. Since the end of Q1, Q2-2018 estimates are higher for five sectors and down for six. Energy's Q2 forecast has risen 7.9%, followed by the forecasts for Real Estate (up 2.5%), Health Care (1.8), Materials (1.3), and Tech (0.2). Consumer Staples is the biggest decliner, with its Q2-2018 forecast down 4.1% since the end of Q1, followed by Financials (-1.6), Telecom (-1.6), Industrials (-1.6), Consumer Discretionary (-1.1), and Utilities (-0.3). The S&P 500's Q2-2018 forecasted earnings gain of 19.8% y/y would be its eighth straight gain after four declines. Ten of the 11 sectors are expected to record positive y/y earnings growth in Q2-2018—with nine rising at a double- or triple-digit percentage rate—and four are expected to beat the S&P 500's forecasted y/y earnings gain of 19.8%. That compares to all 11 sectors rising y/y during Q1-2018, when ten rose at a double-digit pace and four outpaced the S&P 500. Analysts expect Energy to report another large profit jump in Q2 relative to very low earnings a year ago, with the pace improving from Q1. The latest forecasted Q2-2018 earnings growth rates vs their blended Q1-2018 growth rates: Energy (130.0% in Q2-2018 vs 86.4% in Q1-2018), Materials (29.3, 30.0), Tech (23.5, 35.6), Financials (21.2, 30.7), S&P 500 (19.8, 26.2), Consumer Discretionary (15.9, 18.9), Industrials (15.1, 24.7), Telecom (13.1, 14.7), Consumer Staples (10.4, 12.8), Health Care (11.3, 16.2), Real Estate (2.3, 3.1), and Utilities (-0.4, 16.7). On an ex-Energy basis, analysts expect S&P 500 earnings to rise 16.6% y/y in Q2, down from a blended 24.2% in Q1, and compares to 12.7% in Q4-2017 and 6.1% in Q3-2017 (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 nearly 93% of S&P 500 companies finished reporting earnings and revenues for Q1-2018, the earnings metrics are stronger compared to the same point during the Q4 season and the best in seven years, but revenues are a tad weaker than during Q4. Of the 464 companies in the S&P 500 that have reported, 79% exceeded industry analysts' earnings estimates by an average of 7.2%; they have averaged a y/y earnings gain of 24.8%. At the same point

during the Q4-2017 reporting period, a lower percentage of companies (76%) in the S&P 500 had beaten consensus earnings estimates by a lower 4.8%, and earnings were up a lower 16.3% y/y. On the revenue side, 76% beat sales estimates so far, with results coming in 1.1% above forecast and 8.2% higher than a year earlier. At this point in the Q4 season, a higher 79% had exceeded revenue forecasts by a higher 1.3%, and sales rose a slightly higher 8.5% y/y. Q1 earnings results are higher y/y for 86% of companies vs a lower 79% at the same point in Q4, and Q1 revenues are higher y/y for 87% vs 88% a quarter ago. These figures won't likely change much in the coming weeks as investors await retailers' results; it looks like Q1-2018 will mark the seventh straight quarter of positive y/y earnings growth and the strongest since Q4-2010 in part due to lower tax rates.

Contact us by [email](#) or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-775-6823

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