



MORNING BRIEFING

May 31, 2018

Soap & Apple Chips

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

(1) Lots of soaps and stocks to choose from. (2) Consumer Staples got cheaper as bond yield rose this year. (3) Lots of M&A in the Consumer Staples space. (4) Getting hipper. (5) Pepsi goes organic. (6) Others going to the dogs. (7) This is your brain on stem cells. (8) Meet the organoid.

Consumer Staples: Time To Clean Up? Soap isn't a complex product. It's something humans have been using for centuries. Yet there's an inordinate variety on the market. There's soap for your hands and soap for your body. There's bar soap and liquid soap. Soaps have different scents. Some fight bacteria, and some are "natural."

Walmart sells soap from 19 different brands online, including but not limited to: Dial, Dove, Irish Spring Zest, Softsoap, Ivory, Olay, Lever 2000, Coast, Yardley London, Caress, SheaMoisture, Mrs. Meyer's, Tom's of Maine, Safeguard, JR Watkins, Equate, Jergens, and Tone.

Despite the vast array of soap offerings from companies in the S&P 500 Consumer Staples sector, the sector has had a horrible year in the stock market, falling 13.2% ytd. That makes it the worst-performing sector in the S&P 500. Here's the performance derby for S&P 500 sectors ytd through Tuesday's close: Tech (9.8%), Consumer Discretionary (6.7), Energy (2.4), S&P 500 (0.6), Health Care (-0.8), Industrials (-2.0), Financials (-3.9), Materials (-4.3), Utilities (-4.7), Real Estate (-5.6), Telecom Services (-12.3), and Consumer Staples (-13.2) ([Fig. 1](#)).

The Consumer Staples sector peaked at a record high on January 26 and proceeded to fall as interest rates backed up and created competition for the sector's healthy dividend yield. The sector also ran into trouble as Amazon bought Whole Foods and made a push into supplying staples at low prices. In addition, German discount grocers Lidl and Aldi have targeted the US market for expansion making the market ripe for a price war. The S&P 500 Household Products industry's stock price index has fallen 17.4% ytd, Tobacco is 23.6% lower and the Brewers have dropped 25.0%, making them among the worst-performing industries that we track in the S&P 500.

But this is a market that likes to rotate, and it may be time for the Staples sector to clean up. Just in the past week, as the 10-year Treasury bond yield slipped from 3.11% on May 17 to 2.77% on Tuesday, the Consumer Staples sector, along with other sectors that are bond proxies and safety stocks, started to rally. Here's how the sectors have performed for the one week through Tuesday's close: Utilities (2.1%), Real Estate (1.1), Consumer Discretionary (0.4), Consumer Staples (0.3), Tech (0.1), Telecom Services (-1.0), Health Care (-1.2), S&P 500 (-1.3), Industrials (-1.4), Materials (-2.9), Energy (-4.5), and Financials (-5.0) [Table 1](#).

This outperformance could continue if the Treasury bond yield remains around 3.00%. Let's take a look at some of the aggressive moves S&P 500 Consumer Staples companies are taking to break out of

their slump:

(1) *Getting hipper.* The best consumer products companies aren't taking their sector's woes sitting down. They've started shaking up their product offerings, often by buying new, hip brands that appeal to the younger, healthier set, and selling tired offerings. Acquisitions ideally bring in brands that grow faster or have wider margins than the acquirer's existing lines of business.

When Colgate-Palmolive made acquisitions late last year, it opted to buy companies in the professional skin care business, PCA skin and EltaMD. The manufacturer of Irish Spring and Softsoap explained in its [press release](#): "PCA Skin is a leader in medical-grade in-office and take-home skin care products, and has strong support from dermatologists, plastic surgeons and aestheticians. EltaMD is a leading physician-dispensed sun care brand with a unique positioning around broad-spectrum, everyday use, physician-dispensed sunscreen."

Likewise, when Procter & Gamble made an acquisition last month, it purchased the consumer-health business of Germany's Merck KGaA for \$4.2 billion. P&G, which manufactures Ivory and Olay in addition to many other consumer products, adds vitamins and food supplements to its list of offerings through the acquisition.

Colgate shares have fallen 15.8% ytd, while Procter & Gamble's shares have lost 19.4%. Both companies are members of the S&P 500 Household Products stock price index, which has fallen 17.4% ytd ([Fig. 2](#)). The S&P 500 Household Products industry is expected to grow revenue 3.4% this year and 2.6% in 2019 ([Fig. 3](#)). Analysts forecast earnings will grow 8.7% this year and 6.5% next year ([Fig. 4](#)). The industry's forward P/E has fallen from a peak of 22.9 in February 2017 to 17.0 ([Fig. 5](#)).

(2) *Pepsi goes Bare.* PepsiCo [announced](#) last week plans to buy Bare Snacks, which makes chips out of baked fruits and vegetables. The company "was founded in 2001 by a family-owned organic apple farm in Washington, that began selling packaged baked apple chips in local farmers' markets," the press release states. The company will continue to operate independently from its headquarters in San Francisco after the deal closes.

Rival Coca-Cola is turning to alcohol. The company launched a "fizzy lemon-flavored alcoholic drink" in Japan this week. The drink, Lemon-Do, will come in a can and targets both men and women drinkers. While the company owned a winery from 1977 to 1983, this is the first time it has sold an alcoholic drink to consumers. The company also recently introduced new flavors of Diet Coke in North America that gave Q1 beverage sales a boost.

Despite recent innovation and acquisitions, Pepsi shares are down 15.7% ytd, and Coke shares have dropped 7.0%. Both companies are members of the S&P 500 Soft Drinks stock price index, which is down 10.4% ytd ([Fig. 6](#)). The industry's revenue is expected to drop 0.6% this year and increase 3.6% in 2019 ([Fig. 7](#)). Earnings in the Soft Drinks industry are still expected to increase 10.1% this year and 8.0% next year, as the industry's profit margins have improved in recent years ([Fig. 8](#)) and ([Fig. 9](#)). The Soft Drinks' forward P/E has fallen to 18.9, down sharply from a recent peak of 23.0 in August 2017 ([Fig. 10](#)).

(3) *Going to the dogs.* Some consumer companies are looking to the four-legged set for redemption. J.M. Smucker [purchased](#) earlier this month Ainsworth Pet Nutrition for \$1.7 billion and sold its US baking business, including the Pillsbury and Hungry Jack pancake mix brands.

Two-thirds of Ainsworth's sales come from the Rachael Ray Nutrish brand of premium pet food. Smucker already had exposure to the pet business after buying Big Heart Pet Brands three years ago

for \$3.2 billion. The deal brought Meow Mix, Milk-Bone, Kibbles 'n Bits, Natural Balance and Nature's Recipe brands into the Smucker fold.

Smucker isn't the only consumer company going to the dogs. "Other big food makers are adding pets to their product lines, too. General Mills Inc. said in February it would buy pet-food maker Blue Buffalo Pet Products Inc. for \$8 billion as sales of its cereals and yogurts have stagnated. Mars Inc. last year bought veterinary and dog day-care company VCA Inc. for \$7.7 billion," a 4/4 *WSJ* [article](#) reported.

General Mills' shares are down 28.4% ytd through Tuesday's close, while Smucker's shares have fallen 12.5%. Both companies are members of the S&P 500 Packaged Foods & Meats stock price index, which has fallen 14.7% ytd ([Fig. 11](#)). The industry is expected to grow revenue by 6.0% in 2018 and 2.6% next year ([Fig. 12](#)). In line with that, analysts forecast earnings growth of 11.2% this year and 5.7% in 2019 ([Fig. 13](#)). The P/E in the Packaged Foods & Meats industry has dropped sharply to 14.4 from a recent peak of 22.2 in July 2016 ([Fig. 14](#)).

(4) *Kroger gets cooking.* With new players swarming into the grocery business, Kroger opted to increase its bet on the private meal-kit business by buying Home Chef for \$200 million initially and up to \$700 million if Home Chef hits performance targets. The business will combine with Kroger's existing meal-kit business, Prep+Pared meal kits.

Announced last week, the deal follows Albertsons' purchase of Plated last year. "Pentallact Inc., the food consultancy, projects that the multibillion-dollar meal-kit market will continue to grow at about 20% annually," a 5/23 *WSJ* [article](#) reported.

The acquisition follows Kroger's purchase earlier this month of a \$250 million stake in British online grocer Ocado Group. Kroger will increase its stake in Ocado to more than 6%, and it will license from Ocado technology that runs automated warehouses and processes online orders. Kroger will build three warehouses in the US this year and 20 warehouses within three years, and Ocado will operate them.

Kroger is the sole member of the S&P 500 Food Retail index, which has fallen 10.7% ytd ([Fig. 15](#)). Analysts have written off this year's results, but are more optimistic about 2019. In 2018, the industry's revenue is expected to be flat, and earnings are forecast to rise 1.3%. But next year, analysts expect revenue to improve by 3.0% and earnings to jump 8.6% ([Fig. 16](#) and [Fig. 17](#)). This industry's forward P/E has also shrunk to a below-market 11.6 ever since reaching a peak of 22.7 in February 2015 ([Fig. 18](#)).

Health Care: Building Brains. Last weekend's *New York Times* had a special [section](#) listing the top visionaries in their fields. The list was filled with people doing all manner of extraordinary things, but one jumped out at us. Sergiu Pasca, assistant professor of psychiatry and behavioral sciences at Stanford University, is growing mini-human brains. He and colleagues have figured out how to take stem cells and turn them into cells that form the human brain.

Among those who first created "brain organoids" is Madeline Lancaster, a developmental biologist at the Medical Research Council Laboratory in Cambridge, UK. In a 2015 [Ted Talk](#), Lancaster explained that she started by wanting to understand what makes the human brain special. It's big, but so too is the elephant's brain. The human brain, however, contains vastly more neurons in the cerebral cortex, the area of the brain used in higher thinking. So Lancaster set out to discover why human neural stem cells develop so many more neurons than the neural stem cells of other species do.

Scientists can't tinker with a living human's brain, so Lancaster decided to try to build a brain from

scratch. She took neural stem cells and put them in a protein gel that's gently stirred, and brain tissue—called a brain organoid—developed.

The brain organoid isn't identical to a brain. It doesn't have the blood flow that would help it continue to develop. But the composition of two are close enough that experiments can be done on the brain organoid, and scientists believe the results would represent what would happen in a human brain. As a result, brain organoids are being used in experiments that explore various neurological diseases, like microcephaly.

Lancaster took skin cells from a person with microcephaly and used them to create a brain organoid. She discovered that the organoid developed fewer neurons, earlier than a "normal" brain organoid. And now scientists can use CRISPR technology to cut out genes and run tests to see how cells develop in the brain organoid. (We discussed CRISPR in the 3/22 [Morning Briefing](#).)

Pasca, who received the *NYT*'s tip of the hat, grew two organoids that resembled two different brain regions, the cortex and the lower region of the brain. He then put the two different organoids next to each other and found the two organoids "started to communicate and form neural circuits. After he had fed them nutrients for about nine months, they had matured to look more like the cells of a newborn brain than those of a fetus," the article reported. He also discovered that neurons migrate in the brain.

Pasca studies Timothy syndrome, a genetic disease that often results in early death from cardiac problems; people who survive often have autism and epileptic seizures. Children with Timothy syndrome have one mutated gene. By using brain organoids, Pasca discovered that patients with Timothy syndrome have defects in the migration of so-called interneurons to their final destinations in the brain's cortex, as this [video](#) about his work explains.

Pasca's studies are the first step in figuring out how to cure this disease, and the process can be used to work on curing other neurological problems like autism and schizophrenia. Ultimately, scientists hope to use brain organoids to unravel the mystery behind why we've developed into humans and not into elephants.

CALENDARS

US. Thurs: Personal Income & Consumption 0.3%/0.3%, Headline & Core PCED 2.0%/1.8% y/y, Jobless Claims 224k, Weekly Consumer Comfort Index, Pending Home Sales 0.7%, Chicago PMI 58.1, Challenger Job-Cut Report, EIA Natural Gas Report, EIA Petroleum Status Report, Bostic. **Fri:** Payroll Employment Total, Private, and Manufacturing 190k/185k/18k, Unemployment & Participation Rates 3.9%/62.8%, Average Hourly Earnings 0.2% m/m/2.7% y/y, Average Workweek 34.5hrs, Total & Domestic Motor Vehicle Sales 17.1mu/12.8mu, Construction Spending 0.8%, ISM & Markit M-PMIs 58.4/56.6, Baker-Hughes Rig Count. (*Wall Street Journal* estimates)

Global. Thurs: Eurozone CPI Flash Estimate 1.6%/1.1% y/y, Eurozone Unemployment Rate 8.4%, Canada GDP 1.9% (saar), Japan Housing Starts 900k, China Markit M-PMI & NM-PMI 51.4/54.8. **Fri:** Eurozone, Germany, France, and Italy M-PMIs 55.5/56.8/55.1/53.0, Italy GDP 0.3% q/q/1.4% y/y, UK M-PMI 53.5, China Caixin M-PMI 51.2. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators ([link](#)): Our Bull/Bear Ratio (BBR) climbed for the third week to 2.60 this week after declining seven of the prior eight weeks from 3.50 to 2.09—which was the lowest

reading since November 2016. Most of the movement continues to be between the bullish and correction camps. Bullish sentiment rose 6.9ppts the past three weeks to 50.0%—ending nine consecutive weeks below 50.0%—after dropping 4.9ppts to 43.1% the prior two weeks. Meanwhile, the correction count fell 5.5ppts over the three-week span to 30.8% after climbing 3.9ppts to 36.3% the previous two weeks. Bearish sentiment was unchanged at 19.2% this week after edging down the prior three weeks from 20.8%—which was the most bears since November; movements in bearish sentiment have been relatively subdued. The AAI Ratio slipped to 60.5% last week after rebounding the previous two weeks from 48.4% to 64.1%. Bullish sentiment increased from 28.4% to 38.6% the past three weeks, while bearish sentiment climbed to 25.2% last week after falling from 30.3% to 20.6% the prior two weeks.

S&P 500 TCJA Earnings Leaders & Laggards ([link](#)): The 2018 earnings forecast for the S&P 500 has surged 9.9% in the 23 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 0.2ppt from a week earlier even as the post-Q1 earnings season revisions continued to wind down. The top sector gainers since the TCJA was passed: Energy (36.9%), Telecom (16.0), Financials (12.0), Industrials (10.7), and Consumer Discretionary (9.9). Real Estate is the sole decliner, with a drop of 0.5%; also underperforming the S&P 500 are Consumer Staples (1.5), Utilities (2.1), Health Care (7.2), Tech (8.5), and Materials (9.0). Higher oil prices have contributed heavily to the improvement in Energy's 2018 earnings forecast.

S&P 500 Earnings, Revenues & Valuation ([link](#)): S&P 500 consensus forward revenues and earnings rose to another record high last week, but the forward profit margin remained steady. The forward profit margin forecast of 12.2% 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 improved 0.1ppt w/w to 6.2%, 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 rose 0.1ppt w/w to 15.5%. That's down from 16.9% in February, which was the highest since October 2010, but it's up 4.2ppts from 11.1% prior to the passage of the TCJA, and up 10.5ppts 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 7.6% from 7.4%, and earnings growth rose to 21.9% from 21.7%. Looking at last week's results among the 11 sectors, three had a w/w improvement in their forward revenue growth forecast as one fell, and two had forward earnings growth improve as two fell. Energy had both measures improve w/w. Energy's contribution to forward growth peaked at the start of 2017. The S&P 500 ex-Energy's forward growth rose 0.1ppt w/w to 5.7% for revenues and was steady at 14.1% for earnings. The S&P 500 ex-Energy forward profit margin was steady at a record high of 12.8%, which is up from 11.7% before the TCJA. Valuations rose w/w, but remain close to their recent lows. The S&P 500's forward P/E rose to 16.6 from 16.5, which compares to a 16-year high of 18.6 at the market's peak in late January and a recent low of 16.0 in early May. The S&P 500 price-to-sales ratio of 2.02 was up from 2.01, and compares to late January's record high of 2.16 and early May's low of 1.95.

S&P 500 Sectors Earnings, Revenues & Valuation ([link](#)): Consensus forward revenue forecasts rose w/w for six of the 11 sectors, and forward earnings forecasts rose for four sectors. These three had both measures improve w/w: Energy, Health Care, and Industrials. 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 improved w/w with the exception of Real Estate and Utilities. 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 1.33 compares to a record high of 1.56 in May 2016, and its P/E of 19.0 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. Three sectors had their forward profit margins rise 0.1ppt w/w (Consumer Discretionary, Energy, and Tech) and two fell 0.1ppt (Health Care and Real Estate). Here's how the sectors rank based on their current forward profit margin forecasts: Information Technology (22.8%), Financials (18.7), Real Estate (16.1), Telecom (13.4), Utilities (12.3), S&P 500 (12.2), Materials (11.4), Health Care (10.5), Industrials (10.2), Consumer Discretionary (8.3), Consumer Staples (7.7), and Energy (7.0).

US ECONOMIC INDICATORS

ADP ([link](#)): In May, private industries added 178,000 to payrolls, following big downward revisions to both April (to 163,000 from 204,000) and March (198,000 from 228,000), for a net loss of 71,000. (Payrolls averaged monthly gains of 232,750 the prior four months.) According to ADP's chief economist, "Job growth is strong, but slowing, as businesses are unable to fill a record number of open positions. Wage growth is accelerating in response, most notably for young, new entrants and those changing jobs. Finding workers is increasingly becoming businesses number one problem." Service-providing industries (114,000) accounted for roughly two-thirds of May's gain, while goods-producing industries (64,000) registered another strong performance, averaging gains of 53,000 per month the past seven months. Construction (39,000) once again led the strength in goods-producing hiring, although manufacturers (14,000) continued to add to payrolls at a solid rate. Over the past 17 months, construction and manufacturing jobs have increased 364,000 and 278,000, respectively. Natural resources/mining jobs have been rising steadily, posting the largest monthly gain (11,000) in nearly seven years this month. Within service-providing industries, the increase was broad based, with professional & business services (61,000), leisure & hospitality (33,000), and health care & social assistance (26,000) once again leading the pack. By company size, medium-sized companies remained at the top of the leader board, adding 84,000 jobs—46,000 service-providing and 38,000 goods-producing. Large companies moved up to the number two position, boosting payrolls by 56,000—all service providing (59,000); goods-producing industries (-2,000) lost jobs for the first time since December 2016. Meanwhile, small companies moved back down to the bottom slot, adding 38,000 to payrolls—28,000 goods-producing and 10,000 service-providing. Here's the tally by company size over the past 12 months: medium (948,000), large (790,000), and small (504,000)—for a total gain of 2.2 million.

GDP ([link](#)): Real GDP growth for Q1 was revised down slightly to 2.2% (saar), from the advance estimate of 2.3%, on downward revisions to residential investment, inventory investment, and exports—which were nearly entirely offset by a major upward revision to nonresidential fixed investment. Real capital spending accelerated 9.2% (saar), faster than the 6.1% initial gain, and the strongest since Q3-2014. Spending on intellectual property products (to 10.9% from 3.6% advance) expanded at triple the initial estimate, while structures (14.2 from 12.3) and equipment (5.5 from 4.7) also surpassed preliminary growth rates—with the former the fastest in a year. Meanwhile, residential investment (-2.0 from 0.0) contracted, rather than held steady, while real inventory investment (\$20.2 billion from \$33.3 billion) and export growth (4.2 from 4.8) were also weaker than first reported. Real consumer spending (1.0 from 1.1) was little changed from the advance estimate, though there were movements within the components: durable goods (-2.6 from -3.3) spending was slightly less negative than first reported, while nondurable goods (0.4 from 0.1) consumption was slightly more positive; spending on services (1.8 from 2.1) was a bit slower than the preliminary estimate.

Contributions to GDP Growth ([link](#)): Real business investment was the number-one contributor to real GDP growth last quarter, followed by consumer spending. (1) Nonresidential fixed investment

accounted for 1.13ppt of Q1's increase, with investment in intellectual property products (0.43), structures (0.39ppt), and equipment (0.31) all adding to growth. (2) Real consumer spending accounted for 0.71ppt of real GDP growth—all services-related (0.84); goods (-0.13) consumption subtracted from growth for the first time since Q2-2011, all durable (-0.20) goods. (3) Real government spending contributed 0.20ppt to growth last quarter, with federal (0.11) and state & local (0.08) government spending complementing one another. (4) Inventory investment (0.13), which was the biggest negative contributor to Q4 GDP growth, was a positive contributor during Q1—all nonfarm (0.15). (5) Trade (0.08) added to GDP growth again last quarter—after subtracting from growth during Q4 for the first time in a year—as a positive contribution from exports (0.51) more than offset a negative contribution from imports (-0.43). (6) Residential investment (-0.08) was a slight negative contributor during Q1 after contributing positively during Q4 for the first time in three quarters.

GLOBAL ECONOMIC INDICATORS

Eurozone Economic Sentiment Indicators ([link](#)): May's Economic Sentiment Index (ESI) for the Eurozone (-0.2 point to 112.5) was little changed for the second month, while the EU's (+0.4 point to 112.8) more than reversed April's loss. Both measures remained at elevated levels, below their December 17-year highs of 115.2 and 115.1, respectively. This month, ESIs among the Eurozone's five largest economies were mostly lower, though the Netherlands (+1.2 points to 111.7) posted a solid gain, while Germany's (+0.1 to 112.7) was broadly unchanged. Meanwhile, sentiment in France (-1.8 to 108.4), Spain (-1.2 to 109.4), and Italy (-1.0 to 108.4) declined, though remained at comparatively high levels. At the sector level, ESIs for construction (+2.4 to 7.0) and retail trade (+1.4 to 0.7) rose during the month—the former to a new record high—while ESIs for consumer (-0.1 to 0.2), industry (-0.5 to 6.8), and services (-0.5 to 14.3) showed confidence edged lower.

Japan Consumer Confidence ([link](#)): Consumer confidence in May improved for the first time this year, though only slightly. It edged up to 43.8 this month after sinking to an eight-month low of 43.6 last month, though is not far from the four-year high of 44.6 posted from November through January. Three of the four components moved higher this month: overall livelihood (to 42.1 from 41.5), employment (48.2 from 47.9), and willingness to buy durable goods (43.0 from 42.7), while income growth (42.0 from 42.3) continued to retreat. All measures were at relatively high levels.

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