MORNING BRIEFING
June 7, 2018

Vertical Earnings

See the collection of the individual charts linked below.

(1) Handful of S&P 500 industries showing moonshot earnings. (2) Tax cut provided most, but not all, of the rocket fuel. (3) Industries with out-of-this-world earnings mostly in Tech, Consumer Discretionary, Industrials, Materials, and Energy. (4) Amazing Amazon! (5) Entertaining earnings in Movies & Entertainment industry. (6) CAT earnings expectations are hot despite threats of protectionism. (7) Rising commodity promises boosting Energy and Materials earnings, confirming solid global economy. (8) Sandra explains the art of Italian politics. (9) As shown in the opera *Pagliacci*, comedies can end tragically.

Strategy: Earnings Standouts. "Going Vertical" is a movie that broke box office records in Russia this winter. It tells the tale of the 1972 Russian Olympics basketball team, which defeated the US Olympics basketball team for the first time in 36 years in a game that ended after a controversial call by referees. Of course, America has its own feel-good Olympics tale: "Miracle on Ice," a TV movie about the US hockey team beating the Soviet Union in the 1980 games.

"Going vertical" also describes the earnings charts of a handful of S&P 500 industries. These charts stand out because earnings jumped in the beginning of the year—thanks to corporate tax cuts—and surged again in recent weeks, most likely in response to Q1 earnings reports and outlooks for the remainder of the year.

As you'd expect given the Nasdaq's recent climb into record territory, some of these charts belong to industries in the S&P 500 Technology sector, including the Internet Software & Services industry and the Semiconductor Equipment industry. But the same pattern can be seen in Construction Machinery & Heavy Trucks, Paper & Packaging, Steel, and Oil & Gas Exploration & Production. Let's take a deeper look:

(1) *Tech still strengthening*. The S&P 500 Technology sector continues to lead the markets higher. Here's how the S&P 500 sectors have performed y/y as of Tuesday's close: Technology (28.8%), Consumer Discretionary (17.9), Financials (16.9), Energy (16.1), S&P 500 (12.8), Materials (11.4), Industrials (8.7), Health Care (8.4), Real Estate (-1.0), Telecom Services (-8.5), Utilities (-8.6), and Consumer Staples (-13.4).

Most of the S&P 500 sectors' Q1 earnings came in significantly above expectations set as recently as April 1. For example, the Energy sector posted an 86.4% y/y increase in Q1 earnings, which was better than the 71.3% jump analysts expected on April 1, according to Thomson Reuters. Here are the Q1 earnings estimates for the S&P 500 sectors now vs on April 1: Energy (86.4%, 71.3%), Technology (35.9, 23.4), Financials (30.7, 24.4), Materials (30.0, 27.6), Industrials (24.7, 14.6), Consumer Discretionary (19.4, 9.4), Health Care (16.2, 10.7), Utilities (16.7, 10.0), Telecom (14.7, 12.9), Consumer Staples (12.8, 10.9), and Real Estate (3.1, 3.0).

The S&P 500 Semiconductor Equipment industry is one of the industries driving that sharp jump in

Tech earnings estimates. The industry's earnings have been steadily revised upward. The net earnings revisions index (NERI), which is the three-month moving average of the net number of forward earnings estimates that have increased minus those that have decreased, has been strong recently at 35.9% in March, 40.1% in April, and 17.3% in May (*Fig. 1*). Earnings have been improving sharply for roughly two years, and the industry's price index has rallied 16.4% y/y (*Fig. 2*).

The S&P 500 Internet Software & Services industry's earnings have also gone parabolic (*Fig. 3*). They're expected to jump 31.2% this year and 11.9% in 2019 after analysts have sharply revised their estimates upward. NERI was 26.8% in March, 22.9% in April, and 16.3% in May (*Fig. 4*). The industry's price index is up 19.9% y/y.

(2) *Techy retailing*. It may be in the Consumer Discretionary sector, but the S&P 500 Internet & Direct Marketing Retail index, with a 62.9% y/y climb, continues to quack a lot more like a Tech industry. It is one of the best-performing indexes in the S&P 500 overall, and that price action has been supported by earnings that surged in late May (*Fig. 5* and *Fig. 6*). NERI was 12.4% in March, 16.9% in April, and improved to 29.9% in May (*Fig. 7*). Analysts boosted projections for Amazon's 2018 earnings by 48.0% over the past 30 days, and they increased their estimates for the company's 2019's earnings by 27.9%. Amazing! Earnings for the Internet & Direct Marketing Retail industry are now expected to increase 67.8% this year and 39.8% in 2019.

Perhaps the most surprising recent jump in earnings comes from the S&P 500 Movies & Entertainment industry, which includes Disney, 21st Century Fox, and Viacom (*Fig. 8*). NERI was 31.7% in March, 27.5% in April, and 14.1% in May (*Fig. 9*). As a result, earnings are expected to grow 20.0% this year and a more modest 7.1% in 2019. Yet the industry's stock price index is basically flat y/y and has been moving sideways since 2014.

(3) *All talk, no impact*. Talk of tariffs may be wreaking havoc with the stock prices of Industrials, but unless tariffs are actually implemented, earnings in many Industrial industries should continue to improve. Look, for example, at the S&P 500 Construction Machinery & Heavy Trucks industry. The industry's stock price index is down 7.2% ytd, but expected earnings have continued to climb sharply (*Fig. 10* and *Fig. 11*). Earnings are forecasted to increase 45.2% this year and 8.1% in 2019. NERI was 46.0% in March, 39.5% in April, and rose to 41.9% in May (*Fig. 12*). Those are jumps that you just don't see every day.

(4) *Rising prices mean rising earnings*. Rising commodity prices are pushing up earnings in some areas of the S&P 500 Materials and Energy sectors. The price of paper is up 5.1% through April, driving earnings in the industry higher (*Fig. 13*). NERI for the S&P 500 Paper and Packaging industry was 27.3% in March, 26.4% in April, and 23.9% in May (*Fig. 14*). As a result, earnings are expected to pop 41.2% this year and 11.4% in 2019 (*Fig. 15*). The industry's shares, however, have fallen 10.8% from their record high in late January (*Fig. 16*).

Although the price of a barrel of Brent crude oil has dropped back a bit in recent days, it remains up 52% y/y, and that means oil company earnings are gushing as well (*Fig. 17*). The S&P 500 Oil & Gas Exploration & Production industry's NERI was 34.3% in March, 23.4% in April, and 20.8% in May (*Fig. 18*). As a result, earnings have gone vertical, and the industry is expected to increase earnings by 604.5% this year and 19.5% in 2019. The industry's price index is up 23.0% y/y (*Fig. 19*).

Italy: Commedia Dell'arte. Italy's proclivity for colorful and cartoonish Punch-and-Judy-style politics would be funny if it weren't so sad—and if the actions of Europe's fourth-largest economy didn't have profound consequences for world financial markets.

A week ago, global markets were rattled when the Italian President rejected the new Euroskeptic coalition government's candidate for economic minister because of his anti-euro views. That led to the resignation of the new Prime Minister, raised the specter of fresh elections, threw the future of the euro into doubt, and prompted a selloff in financials stocks (*Fig. 20*). German bunds and US Treasuries proved to be safe havens amid the turmoil.

The ringleaders—a.k.a. deputy ministers—of the new populist government, the Five Star Movement's Luigi Di Maio, who is also the minister of Labor and Industry, and the League's Matteo Salvini, also the interior minister, moved quickly to offer a compromise candidate for economic minister. That prompted the return and reinstatement of the little-known law professor Giuseppe Conte as Prime Minister. Pressures on Italian bond prices eased, and a four-day rally ensued as some semblance of stability was restored. The euro staged a comeback.

Yet on Tuesday, as the new government officials appeared before the Italian Parliament ahead of a confidence vote, Italian bonds sold off again as Conte laid out "revolutionary measures." His spending and tax plans unquestionably will put Italy at odds with the budgetary rules of the European Union, according to a 6/5 Bloomberg report. Former Italian Prime Minister Mario Monti, who steered the country through the debt crisis of 2011, told Reuters in a 6/5 article that Italy risks being put under the supervision of the "troika": the European Central Bank (ECB), the European Commission, and International Monetary Fund (IMF).

We addressed Italy's political crisis in our 5/30 *Morning Briefing*. I asked Sandra Ward to review the latest developments. Here's her report:

(1) *"New winds of change."* That's what Prime Minister Conte promised in his speech to Parliament on Tuesday. Flanked by puppet masters Di Maio and Salvino, he laid out a spending and tax plan in which his government will push through a "citizen's income" for the poor and jobless, implement a two-tiered flat tax, and boost health spending, the Bloomberg article cited above reported. In addition, he vowed to reduce the massive public debt, which at €2.3 trillion represents more than 130% of GDP. Austerity is out; largesse is in. Carlo Cottarelli, an economist and former IMF director who was in line to be interim Prime Minister, put the cost of the proposed spending programs at €126 billion in the first year.

(2) *Bonds sell off, again.* Following Conte's speech to Parliament on Tuesday, two-year yields rose to 1.06% from 0.77% and 10-year yields on Italian debt jumped to 2.77% from 2.55% (*Fig. 21* and *Fig. 22*). The spread between the Italian and German 10-year government bond yields has widened dramatically since late April (*Fig. 23*).

Borrowing costs across the Eurozone rose on Wednesday following remarks by two top ECB officials suggesting that the central bank will halt its bond-buying stimulus program by the end of this year. Underlying strength in the economy is driving wages higher and pushing inflation toward the ECB's target of "below but close to 2%," explained a 6/6 *FT* article. The spread between the Italian 10-year yield and its German equivalent widened further to 247.6 basis points.

(3) *ECB scales back Italian debt purchases.* At the peak of concerns about Italy's political future in May, the ECB cut back its purchases of Italian debt, according to a 6/5 story in MarketWatch. The ECB explained the move as a matter of timing: A large chunk of German debt expired in April, and the bank needed to buy more German debt to replace it. Italian politicians complained that the move exacerbated the selloff in Italian bonds.

(4) *The "doom loop."* The FTSE Italia All-Share Banks Index lost 3.36%, or 342.86 points, on Tuesday to close at 9868.14 as investors fretted about bank exposure to Italian sovereign bonds. Moody's

Investors Service placed the credit ratings of 12 banking institutions under review last week for a possible downgrade, following a similar review of the country's public debt, citing the risk of "material weakening" in its fiscal strength as a result of the new government's policies. A 6/5 piece in the *FT* referred to the tendency of Eurozone banks to hold a high proportion of government debt as the "doom loop." Italian sovereign bonds accounted for nearly 10% of assets at Italian banks at the end of 2017, the article noted. Lenders with the biggest exposure include Intesa Sanpaolo, which had €76 billion at the end of 2017, and UniCredit with €54.5 billion.

Uncertainty about Italy's new government and the potential euro instability are mainly to blame for the underperformance of European financials (*Fig. 24*).

(5) *UniCredit-SocGen merger?* Amid the upheaval in Italy politics, Italy's biggest bank is exploring a merger with France's SocGen, the *FT* reported in a 6/3 scoop. Talks have been underway for several months. UniCredit's CEO has been vocal about the need for cross-border, pan-European bank combinations to stay competitive with their US rivals. The ECB is also a proponent of more cross-border deals. Any merger between the two could be a year away, as UniCredit in the meantime seeks to shore up its balance sheet and as SocGen continues to negotiate an agreement with regulators over its role in a Libor rate-rigging scandal among other probes.

(6) *Merkel's response.* In an interview with the *Frankfurter Allgemeine Sonntagszeitung* newspaper on Sunday, German Chancellor Angela Merkel outlined her plan for reforming the European Union (EU) and accepted some blame on the part of Germany for the divisions besetting Europe, noted a 6/3 Reuters piece.

On Italy, she promised to be "respectful" and said she wanted to work with its new government but drew the line at debt relief. "Solidarity among euro partners should never lead to a debt union, rather it must be about helping others to help themselves," Merkel said. She continues to reject the transference of peripheral country debt and fiscal obligations onto Germany but proposed a European Monetary Fund that could provide short-term loans should extraordinary circumstances saddle member states with financial difficulties.

On immigration, Merkel said she envisions a common system of asylum standards, a European border security agency, and a European refugee agency, and she acknowledged that Germany's past efforts to impose mandatory quota systems on member states was a mistake, according to a 6/4 column in the *FT* by a senior fellow at the Brookings Institution.

(7) *Conte's response.* With illegal immigration at the forefront of the populist agenda in Italy, Conte made it a focal point of his speech before Parliament. He accused the EU of burdening Italy with the task of dealing with immigrants from across the Mediterranean and noted that Merkel's recent comments show that EU leaders are "realizing Italy cannot be left on its own in the face of such challenges."

(8) *Salvini's response.* Interior Minister Salvini of the League, meanwhile, pledged at an anti-immigration rally in Rome on Tuesday to "change the rules of this European Union" together with Hungary's Prime Minister Viktor Orban, another anti-immigrant, right-wing, populist who recently helped to elect hard-liner Janez Jansa in Slovenia.

At a time when the EU is increasingly anxious about a shift away from democratic principles among certain member states, and is considering limiting aid to those—including Hungary and Poland—that flout the rule of law by increasing state control over their news media and judiciary bodies, an Italian alliance with Hungary may have more ominous implications for the future of the EU and its single currency than Italy's inability to stay within the budget rules.

CALENDARS

US. Thurs: Jobless Claims 225k, Consumer Credit $14.0b, Chain Store Sales, Weekly Consumer Comfort Index, EIA Natural Gas Report. **Fri:** Wholesale Trade Inventories 0.1%, Baker-Hughes Rig Count. (*Wall Street Journal* estimates)

Global. Thurs: Eurozone GDP 0.4%q/q/2.5%y/y, Germany Factory Orders 0.8%m/m/3.6%y/y, Japan GDP -0.5%(saar), Japan Leading & Coincident Indexes 105.6/117.8. **Fri:** Germany Industrial Production 0.3%m/m/2.8%y/y, Germany Trade Balance €20.2b, UK BOE/TNS Inflation Next 12 Months, Canada Employment Change & Unemployment Rate 22k/5.8%, Canada Housing Starts 220k, China Trade Balance $32.5b, China Foreign Direct Investment. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): Our Bull/Bear Ratio (BBR) climbed for the fourth week to 2.99 this week after declining seven of the prior eight weeks from 3.50 to 2.09—which was the lowest reading since November 2016. Bullish sentiment rose 9.8ppts the past four weeks to an 11-week high of 52.9%, after dropping 4.9ppts to 43.1% the prior two weeks. Meanwhile, the correction count fell 6.9ppts over the four-week span to 29.4% after climbing 3.9ppts to 36.3% the previous two weeks. Bearish sentiment slipped to 17.7% this week—the lowest since late March; five weeks ago, it was at 20.8%, which was the most bears since November. The AAII Ratio slipped for the second week to 57.1% last week after rebounding the previous two weeks from 48.4% to 64.1%. Bullish sentiment fell to 35.0% after increasing the previous three weeks from 28.4% to 38.6%, while bearish sentiment climbed for the second week to 26.4% last week after falling from 30.3% to 20.6% the prior two weeks.

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 was steady w/w at 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, at 15.5%, was also unchanged w/w. 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 was steady at 7.6%, but earnings growth rose 0.1ppt to 22.0%. Looking at last week's readings among the 11 sectors, three had a w/w improvement in their forward revenue growth forecast, and four had forward earnings growth improve as one fell. Consumer Discretionary, Consumer Staples, and Energy had both measures improve w/w. Energy's contribution to forward growth peaked at the start of 2017. The S&P 500 ex-Financials forward growth forecasts rose 0.1ppt each w/w, to 6.5% for revenues and to 14.5% for earnings. The S&P 500 ex-Financials forward profit margin was steady at a record high of 11.3%, which is up from 10.4% before the TCJA. Valuations rose w/w, but remain close to their recent lows. The S&P 500's forward P/E edged down to 16.5 from 16.6, 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 2.01 was down from 2.02, 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 seven of the 11 sectors, as did forward earnings forecasts. These four sectors had both measures improve w/w: Consumer Discretionary, Consumer Staples, Energy, 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, although most improved w/w. Energy's valuations remain elevated relative to historical levels, but are slowly returning to normal now after soaring in 2016 when revenues and earnings collapsed. Energy's P/S ratio of 1.31 compares to a record high of 1.56 in May 2016, and its P/E of 18.6 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. Two sectors had their forward profit margin rise 0.1ppt w/w: Real Estate and Utilities. Here's how the sectors rank based on their current forward profit margin forecasts: Information Technology (22.8%), Financials (18.7), Real Estate (16.2), Telecom (13.4), Utilities (12.4), 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

Productivity & Labor Costs (*link*): Nonfarm productivity growth remained below 1.0% during Q1, while unit labor costs rose at their fastest pace in a year. Productivity (to 0.4% from 0.7%, saar) expanded at a slightly slower pace than previously reported, nearly matching Q3's 0.3% pace. Revisions show output (2.7 from 2.8) grew slightly slower and hours worked (2.3 from 2.1) were slightly higher, slowing from gains of 3.7% and 3.3%, respectively. Unit labor costs (2.9 from 2.7) were slightly faster, accelerating steadily from Q2-2017's -1.2%. Meanwhile, the hourly comp (3.3 from 3.4) rate was up from Q4's 2.9%, but below the 5.0% pace at the start of last year. On a year-over-year basis, productivity expanded 1.3%, in line with 2017's annual growth rate of 1.0%. (Over the past five years, productivity growth has averaged gains of just below 1.0%.) Output rose 3.6% y/y, while hours worked was 2.3% above a year ago; meanwhile, unit labor costs rose 1.3% y/y as hourly comp advanced 2.6%.

Merchandise Trade (*link*): The real merchandise trade deficit narrowed for the second month in April, after posting its largest deficit since January 2006 during February, suggesting that trade could give a boost to real GDP this quarter. April's deficit narrowed to a seven-month low of -$77.5 billion, after widening steadily from -$76.1 billion last June to -$85.4 billion this February. April's deficit was considerably below Q1's average monthly deficit of -$82.5 billion. April real merchandise exports were little changed after a two-month jump of 5.1% to a new record high; real merchandise imports fell for the second month, by 0.4% m/m and 1.6% over the period, but remained in record territory. Real exports were mixed in April, with gains in food (7.0%), industrial supplies & materials (1.9), and consumer goods ex autos (0.4) offsetting declines in exports of capital goods ex autos (-3.3) and autos (-1.5). Real exports of industrial supplies & materials reached a new record high in April, while the other components were near record readings. Real imports were also mixed, with gains in industrial supplies & materials (2.5), capital goods ex autos (0.7), and food (0.7) nearly offsetting declines in imports of consumer goods ex autos (-5.2) and autos (-3.0).

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