



MORNING BRIEFING

June 14, 2018

Equilibrium Oil?

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

(1) Tug of war in the oil patch. (2) Miracle on oil: US producing a record 10.8 mbd. (3) OPEC meets next week as Saudis and Russians up output. (4) Venezuela is a mess, and Iran is facing renewed sanctions. (5) Tipping point for renewables. (6) Cheaper batteries. (7) That's entertainment. (8) Tug of war between cost-push inflation and robots.

Energy: Balance Returns. There are more pushes and pulls affecting the price of crude. On the bearish side, the shale miracle continues to boost production in the US, OPEC quotas are up for debate at next week's meeting, and Saudi Arabia and Russia have already started pumping more oil. And on the horizon, electric vehicles could weigh on oil demand if they're broadly adopted. On the bullish side, renewed US sanctions against Iran could lower that country's production, the dissolving society in Venezuela has crippled its oil industry, and the strong global economy has helped boost demand.

The US Energy Information Administration's forecast calls for an oil market that's in amazing balance. This year, it expects worldwide crude oil and liquid fuels production of 100.22 million barrels per day (mbd) and worldwide consumption of 100.29 mbd. The oil market has already placed its bet: The price of a barrel of Brent crude oil has jumped to \$75.88, up 57% y/y ([Fig. 1](#)). But now it might move sideways for a while. Let's take a closer look at the oil market ledger:

(1) *Production increasers.* The US oil miracle continues to keep the markets well supplied. US crude oil production jumped to 10.8 mbd at the start of this month, an all-time record ([Fig. 2](#)). Current production has increased 1.4 mbd from last year, helped along by the growing number of rigs deployed ([Fig. 3](#) and [Fig. 4](#)). Despite the increased production, US crude stocks fell last week by 4.1 million barrels, more than the expected drop of 2.7 million barrels.

OPEC and Russia had cut oil production by 1.8 mbd since January 2017 in an effort to reduce inventories that had grown thanks in part to US production. But with the price of Brent recently popping over \$80 a barrel, the oil industry leaders may consider their inventory-reducing job done.

Both Saudi Arabia and Russia reportedly have started pumping more oil in advance of next Friday's OPEC meeting, where "official" production cuts are expected to be discussed. Russian production reportedly increased to 11.1 mbd earlier this month, which is 143,000 barrels a day above the country's OPEC quota. It's the third month in a row that Russia has pumped more than its quota, reported a [6/11 article](#) in [Oilprice.com](#).

Likewise, Saudi Arabia's production rose by 161,400 barrels a day m/m in May, which brought its monthly production to just over 10 mbd, higher but still within its quota, a CNBC [article](#) reported Tuesday.

(2) *Production decreasers.* Venezuela continues to see its oil production shrink. Its production fell to 1.6

mbd, down from 2.2 mbd in 2016 and almost half the 3.0 mbd it produced in 1997. “Venezuela's oil sector has been plagued by spiraling debt, mismanagement, corruption, crumbling infrastructure and a lack of investment,” according to a 4/12 [article](#) in S&P Global Platts. “Sources have told S&P Global Platts production and exports have been tumbling in the past year as state oil company PDVSA has been struggling to secure diluents and other chemicals needed to pump crude, keeping its refineries operational and maintaining deteriorating infrastructure.”

Potential oil production decreases in the future may come from Iran. In May, the US announced it would reinstate sanctions against Iran and any companies doing business in Iran. European and Asian banks, insurers, and oil companies may have to reduce their business in Iran as a result, and that could dent Iran's oil production by the end of this year, according to the EIA.

“Iran's OPEC governor, Hossein Kazempour Ardebili, told Reuters last week that the oil price could jump to \$140 if U.S. sanctions hurt his oil exports from this country, the third biggest producer in OPEC behind Saudi Arabia and Iraq,” a 6/12 Reuters [article](#) reported. The article addressed concerns that the worldwide industry's spare capacity could shrink from “more than 3 percent of global demand now to about 2 percent, its lowest since at least 1984, if [OPEC], Russia and other producers decide to increase output” when they meet next week.

(4) *The renewable wild card.* The impact that renewable energy and electric cars will have on the oil industry is the ultimate wild card. The price of deploying renewables has now become competitive with that of using other fuels, and the variety of electric cars and deployment of electric chargers have increased dramatically. While not scientific, it feels like a tipping point may be approaching.

The 6/11 *WSJ* presented a great [article](#) about the state of the renewables industry. “In 2017, the global average cost of electricity from onshore wind was \$60 per megawatt hour and \$100 for solar, toward the lower end of the \$50 to \$170 range for new fossil-fuel facilities in developed nations, according to the International Renewable Energy Agency,” the article reported.

At the same time, spending to develop renewable sources has increased. “In 2016, the latest year for which data is available, about \$297 billion was spent on renewables—more than twice the \$143 billion spent on new nuclear, coal, gas and fuel oil power plants, according to the IEA. The Paris-based organization projects renewables will make up 56% of net generating capacity added through 2025,” the article states.

Similarly, the drop in battery prices has started to make electric vehicles a viable alternative to gasoline-powered cars. Battery prices fell 35% last year, and by 2040, long-range electric cars will cost less than \$22,000 in today's dollars and account for 35% of all new vehicle sales, according to projections cited in a 2/25 Bloomberg [article](#).

The article then assumes EV sales continue to grow by 60% annually worldwide (matching what they did last year) through 2023. If that occurs—and it's undoubtedly a mega “if”—it would replace oil demand of 2 million barrels a day by 2023, potentially creating a glut equal to the one that caused the 2014 oil drop. A drop in demand is certainly not priced into today's oil prices. EV demand is undoubtedly something oil investors will need to watch.

(5) *Energized energy stocks.* As you'd expect, the resurgent price of oil has boosted earnings expectations in the oil industry. The S&P 500 Oil & Gas Exploration & Production industry was perhaps hurt the worst by the oil glut, and now it stands to rebound the most. The industry's revenues are expected to jump 19.7% this year and 7.5% in 2019 ([Fig. 5](#)). Likewise, earnings for the industry are forecast to surge 601.4% this year and 20.2% in 2019 ([Fig. 6](#)). The industry's stock price index has

climbed 25.2% y/y, almost twice the S&P 500's 14.7% return over the same time ([Fig. 7](#)).

The Energy industry's stock price index with the best one-year performance is S&P 500 Oil & Gas Refining & Marketing, with a 53.6% y/y gain ([Fig. 8](#)). The industry is expected to see 2018 revenue growth of 15.6%, slowing to 3.7% growth in 2019 ([Fig. 9](#)). Meanwhile, earnings are forecasted to grow 45.2% this year and 30.0% in 2019 ([Fig. 10](#)). Despite the strong earnings growth, the industry's forward P/E has climbed toward the top of its normal range, at 14.1.

Two other Energy industries that analysts expect to generate booming earnings are the S&P 500 Oil & Gas Drilling industry (returning to a profit in 2018 and growing earnings 60.2% in 2019), and the S&P 500 Oil & Gas Equipment & Services industry (59.9% earnings growth in 2018 and 49.9% growth in 2019).

Entertainment: Netflix Wannabes. A federal judge's ruling, after the close on Tuesday, allowing AT&T to purchase Time Warner caused a major rally in the stocks of content creators that are considered potential targets. CBS jumped 3.6% Wednesday, while 21st Century Fox soared 7.7%, and even AMC Networks and Lions Gate Entertainment added 3.0% and 3.1%.

Normally, you'd assume that the shares of Netflix, the company everyone is gunning for, would fall for fear that the competition is heating up. That wasn't the case, however. Netflix shares rallied 4.4% Wednesday. Here's our guess as to why: All content is not created alike. Netflix is the best. HBO is a distant second, and everyone else trails far, far behind.

Netflix isn't succeeding only because you can get its service anywhere. These days, most TV shows can be streamed at any time on demand on a TV, PC, or mobile device. Netflix is succeeding because it has amazing content. It's like HBO was in the 1990s, when office chatter was often about what happened on *Sex in the City* the night before. But instead of having a handful of hot shows as HBO did, Netflix has scores of them, and keeps producing more.

Jackie is addicted to two Netflix shows: *Grace and Frankie* and *The Crown*. Grace and Frankie are played by Jane Fonda and Lilly Tomlin. The acting and writing are fantastic, she reports. The same can be said of *The Crown*, which is filled with history and amazing cinematography, which I also enjoy. When was the last time a show about history or women in their 70s got any time on CBS, NBC, ABC or the smaller cable channels? Not since NBC's hit *The Golden Girls* went off the air in 1992.

AT&T was smart to move first, because TimeWarner's HBO is as close as you can get to Netflix-like programming. Unless media companies change the way they approach programming, all that acquirers may be getting with future deals is a lot more debt, not many more subscribers.

The entertainment industry finds itself with low earnings multiples as it wades through all the M&A drama. Here's a look at some of the highlights:

(1) The S&P 500 Broadcasting stock price index (CBS, DISCA, and DISCK) has fallen 7.1% y/y and has essentially moved sideways since 2012 ([Fig. 11](#)). It's expected to grow revenue in 2019 by 6.6% and earnings by 16.3% ([Fig. 12](#)). As a result, the industry's forward P/E has fallen from roughly 20 in January 2014 to a recent 8.1 ([Fig. 13](#)).

(2) The S&P 500 Cable & Satellite stock price index (CHTR, CMCSA, and DISH) is down by 20.7% y/y ([Fig. 14](#)). The industry's revenue is forecasted to grow 2.3% in 2019, and earnings are expected to increase 12.9% that year as well ([Fig. 15](#)). Here too, the industry's forward P/E has fallen sharply, to 15.1 ([Fig. 16](#)).

(3) The S&P 500 Movies & Entertainment stock price index (DIS, FOX, FOXA, TWX, and VIAB) has the best-looking chart of the three industries and has risen 2.8% y/y ([Fig. 17](#)). It's expected to improve revenue by 3.6% in 2019 and earnings by 7.1% ([Fig. 18](#)). Its P/E also has fallen in recent years to 13.1 ([Fig. 19](#)).

Tech: Inflation vs Robots. In recent weeks, there has been a bevy of stories about price increases in various industries. We'd be much more concerned about those stories if it weren't for another batch of articles about robots that has also filled the news media. Any businessperson facing price increases needs only to consider how to deploy robots—or any technology for that matter—to cut costs. Let's take a look at both sides of the equation:

(1) *Some commodities percolating.* Sometimes, prices rise because of demand. Sometimes, they rise because of tariffs. The price of cotton has jumped 26% since its recent low on February 14, partially because China has reentered the market as a large buyer after years of living off of its stockpiles. In addition, the market is concerned about drought conditions in cotton-growing areas down South.

China may also be trying to reduce its trade deficit with the US. The country offered to buy almost \$70 billion of US farm, manufacturing, and energy products if the Trump administration ends threats to place tariffs on \$50 billion of Chinese imports.

The price of steel has also been affected by trade policies. Steel has risen because of the 25% tariff President Trump placed on US imports earlier this year. The price of hot-rolled coil US steel has jumped roughly 40% ytd, putting pressure on all sorts of industries that depend on the metal.

Copper prices also have surged nearly 10% since this year's low on March 26, but the Trump administration isn't to blame here. The strong global economy—combined with labor and political unrest in Brazil, a major copper producer—also has boosted prices. Although metals prices have increased, the overall CRB Raw Industrials spot price index is back in the same neighborhood it traded in from 2011 through 2014 ([Fig. 20](#)).

(2) *Pricier coffee.* Meanwhile, last week brought news that Starbucks, Smucker, and airlines all are increasing their prices. Starbucks raised prices between 10 cents and 20 cents on all brewed coffees. The company explained that store operating expenses rose 9% y/y, and its cost of sales rose 13% y/y.

May we suggest Starbucks take a look at Spyce, a restaurant started in Boston by robotic engineers from MIT? Human chefs have been replaced by seven automated cooking pots that can cook a meal in three minutes or less.

Michael Farid, a co-founder, explained in a 5/17 *Washington Post* [article](#): "Once you place your order, we have an ingredient delivery system that collects them from the fridge," Farid said. "The ingredients are portioned into the correct sizes and then delivered to a robotic wok, where they are tumbled at 450 degrees Fahrenheit. The ingredients are cooked and seared. And once the process is complete, the woks tilt downward and put food into a bowl. And then they're ready to be garnished and served."

(3) *Higher prices in Aisle 8.* J.M. Smucker told investors it had to raise prices on some foods because higher costs were hurting profitability. Perhaps Smucker should call RobotWorx. That company's [website](#) touts its robots' ability to perform better than humans in food manufacturing.

"For the packaging of food items, where speed, consistency or high levels of repetition are concerned, the food robot almost always wins over humans in terms of efficiency. Robots are equipped with

intelligent vision systems allowing the very specific placement of products on a belt to be done with incredible accuracy. Vision system robots are also utilized in sorting by color, shape or size,” the website states. It goes on to say that the robots have gotten better at gripping delicate items. They have an airflow vacuum tool for goods with surfaces that can be damaged and “finger grippers” that can be changed over and over and are easy to clean.

We'll continue watching the yin and yang of higher prices and the rollout of robots.

CALENDARS

US. Thurs: Retail Sales Total, Ex Autos, Ex Autos & Gas, and Control Group 0.4%/0.5%/0.4%/0.4%, Business Inventories 0.3%, Jobless Claims 225k, Weekly Consumer Comfort Index, Import & Export Prices 0.5%/0.3%, EIA Natural Gas Report. **Fri:** Headline & Manufacturing Industrial Production 0.1%/0.1%, Capacity Utilization Rate 78.0%, Empire State Manufacturing Index 19.1, Consumer Sentiment Index 98.5%, Treasury International Capital, Baker-Hughes Rig Count. (*Wall Street Journal* estimates)

Global. Thurs: Germany CPI 0.5%_{m/m}/2.2%_{y/y}, UK Retail Sales Including & Excluding Auto Fuel 2.4%/2.5% _{y/y}, Japan Industrial Production, China Retail Sales 9.6% _{y/y}, China Industrial Production 7.0% _{y/y}, China Fixed Assets Ex Rural (ytd) 7.0% _{y/y}, Australia Employment Change & Unemployment Rate 19k/5.6%, ECB Central Bank Rate 0.00%, ECB Margin Lending Facility & Deposit Facility Rate 0.25%/-0.40%, Draghi. **Fri:** Eurozone Headline & Core CPI 1.9%/1.1% _{y/y}, Eurozone Trade Balance €20.0b, BOJ 10-Year Yield Target, BOJ Rate Decision. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators ([link](#)): Our Bull/Bear Ratio (BBR) advanced for the fifth week to 3.12—the first reading above 3.00 since the week of March 20. Before the recent move up, the BBR had declined seven of the prior eight weeks from 3.50 to 2.09—which was the lowest reading since November 2016. Bullish sentiment climbed 12.4ppts the past five weeks to a 12-week high of 55.5%, after dropping 4.9ppts to 43.1% the prior two weeks. Meanwhile, the correction count fell 9.6ppts over the five-week span to 26.7% after climbing 3.9ppts to 36.3% the previous two weeks. Bearish sentiment ticked up to 17.8% this week from 17.7% last week—which was the lowest reading since late March; six weeks ago, it was at 20.8%, which was the most bears since last November. The AAI Ratio climbed to 59.3% last week after falling the prior two weeks from 64.1% to 57.1%. Bullish sentiment rose for the fourth time in five weeks from 28.4% to 38.9% over the period, while bearish sentiment increased for the third week to 26.7% after falling the previous two weeks from 30.3% to 20.6%.

S&P 500 Earnings, Revenues & Valuation ([link](#)): S&P 500 consensus per-share forecasts for forward revenues and earnings rose to another record high last week, but their forward growth forecasts fell w/w as increasing weight was placed on their lower, but still improving y/y growth forecasts for 2019. The forward profit margin remained steady at a record high of 12.2%, 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 dropped w/w to 6.0% from 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. The annual 2018 and 2019 revenue growth forecasts each rose 0.1ppt w/w to 7.7% and 4.9%, respectively. Forward earnings growth dropped 0.9ppt to a 21-week low of 14.6% from 15.5%. That's down from 16.9% in February, which was the highest since October 2010, but it's up 3.5ppts from 11.1% prior to the passage of the TCJA, and up 9.8ppts from the cyclical low of 4.8% in February 2016. Turning to the annual earnings growth expectations, the earnings growth forecast for 2018 was steady w/w at 22.1% and the one for 2019 rose 0.1ppt to 9.8%. Energy's contribution to forward growth peaked at the start of

2017. The S&P 500 ex-Financials forward revenue growth forecast dropped 0.3ppt w/w to 6.2%, and the forward earnings growth forecast dropped 0.8ppt to 13.7%. 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, putting some distance between current levels and recent lows. The S&P 500's forward P/E rose w/w to 16.7 from 16.5, which compares to a 16-year high of 18.6 at the market's peak in late January and its recent low of 16.0 in early May. The S&P 500 price-to-sales ratio of 2.04 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 10 of the 11 sectors, and forward earnings forecasts rose for all 11 sectors. Health Care was the only sector that didn't have both measures improve w/w. The per-share measures for forward revenues and earnings are at or around record highs for 4/11 sectors: Consumer Discretionary, Health Care, Industrials, and Tech. Forward margins are at record highs for 8/11 sectors, all but Energy, Health Care, and Real Estate. 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. Looking at last week's readings for forward growth among the 11 sectors, just two (Financials and Utilities) had a w/w improvement in their forward revenue growth forecast as seven fell, and Real Estate was the only sector with a w/w improvement in forward earnings growth. These six sectors had both forward growth measures fall w/w: Consumer Discretionary, Consumer Staples, Energy, Materials, Tech, and Telecom. Forward P/S and P/E ratios are down from their recent highs in early 2018 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 1.29 compares to a record high of 1.56 in May 2016, and its P/E of 18.0 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. Two sectors had their forward profit margin rise 0.1ppt w/w: Energy and Materials. 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 (11.5), Health Care (10.5), Industrials (10.2), Consumer Discretionary (8.3), Consumer Staples (7.7), and Energy (7.1).

GLOBAL ECONOMIC INDICATORS

Global Leading Indicators ([link](#)): In April, the OECD's composite leading indicators (CLIs)—designed to anticipate turning points in economic activity relative to trend six to nine months ahead—once again pointed to stable growth momentum in the OECD (99.9) as a whole. Among the major economies, the US (100.2) continued to anticipate stable growth momentum; that's also the assessment for Japan (99.9)—which showed signs of easing growth momentum in the prior report; Canada (99.9) continued to show signs of easing growth momentum. Looking at the European economies, CLIs for Germany (100.3), France (99.8), Italy (100.2), and the Eurozone (100.1) as a whole now confirm that growth momentum is easing, which continues to be the assessment for the UK (99.0). Among emerging economies, India's CLI (101.2) continued to signal growth gaining momentum, while China's (99.1) industrial sector is tentatively showing growth gaining momentum. Russia's CLI (101.0) still points to stabilizing growth momentum, now joined by Brazil (103.8)—which was showing signs of gaining momentum in the previous report.

Eurozone Industrial Production ([link](#)): Output in April fell for the fourth time in five months since reaching a new cyclical high in November. Industrial production (excluding construction) slumped 0.9% in April and 2.0% from November's peak. April's decline was widespread, with only production of capital goods in the plus column, rebounding 1.9% after a 3.7% drop during the two months ending March. Energy output (-5.0%) led April declines, followed by consumer durable (-2.2), consumer nondurable (-

1.2), and intermediate (-0.8) goods production. It was the fourth straight decline in intermediate goods output, for a ytd loss of 2.9%. Consumer durable goods output was down 3.8% over the same period; consumer nondurable goods production is stalled around record highs. Data available for the top four Eurozone economies show all contracted last month: Spain (-1.9%), Germany (-1.7), Italy (-1.2), and France (-0.6). Among the member states, the largest losses were posted by Lithuania (-7.9), the Netherlands (-4.4), and Greece (-3.3), with Ireland (9.1) posting the biggest gain—following a two-month slide of 15.8%.

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