MORNING BRIEFING
June 21, 2018

Weighty Matters

See the collection of the individual charts linked below.

(1) Dropping GE. (2) IT and Health Care have been earnings-share gainers. (3) Four earnings-share losers. (4) S&P 500 Telecom Services will morph into Communication Services after September 28. (5) Time to go shopping for REITs? (6) REITs are depressed, so largest buyers in the real estate industry are snapping them up. (7) Apple hires Oprah and other celebs to catch up with Netflix. (8) Red Bull is bullish on gamers.

Sectors: Earnings & Market Cap Shares. General Electric's ouster from the DJIA could be seen in two different lights. A pessimist might say that it's the latest confirmation that US manufacturing is waning, that industrial America isn't moving fast enough to stay vibrant. The fact that GE has been replaced by a company in the health care industry is an even bigger kick in the pants. Is providing health care to an aging population the only thing at which America excels?

We prefer a more positive twist. Although GE had a fabulous run as a member of the DJIA for more than a century, America thrives on creative destruction, and change is good. Now, we could easily argue that it would have been more appropriate to replace GE with Amazon or even Facebook. But we'll leave that debate for another day. Instead, let's take a look at how the earnings contributions of the S&P 500's sectors have changed over the years and whether the market capitalizations have kept pace:

(1) *Earnings-share gainers.* The S&P 500 Information Technology sector has watched its earnings become an increasingly large contributor to the earnings generated by companies in the S&P 500. The sector kicks in 23.3% of the S&P 500's earnings, a record amount that has surpassed the 2000 peak of 19.8% since December 2014. Tech stocks have recently gotten a little ahead of earnings, as Tech stocks represent 26.2% of the S&P 500's market capitalization (*Fig. 1*). The difference has been greater during and immediately after the "bubble years," and it's certainly something to keep an eye on.

Health Care is the other S&P 500 sector that has increased its earnings contribution to the S&P 500, to 15.3%, up from around 9.5% during 2000. Despite this jump in earnings, the sector's stocks have not kept pace. The Health Care market capitalization is 14.0%, and has lagged the sector's earnings contribution since roughly 2014 (*Fig. 2*).

(2) *Earnings-share losers*. Industrials has, over time, been one of the sectors that have watched its earnings fall as a percentage of the S&P 500's total earnings. The sector's earnings contribution peaked at 19.5% in January 1989, only to fall to 10% to 12% since 2000. It currently stands at 9.9%, which is also the sector's market capitalization share (*Fig. 3*).

The Telecom Services sector has also watched its earnings share dwindle, from roughly 8% in the late 1990s to a recent 2.9%; however, this fall it will be getting a facelift (*Fig. 4*). Telecom will be transformed into the Communication Services sector and be joined by other tech and media heavyweights like Disney, Comcast, and Netflix. The Consumer Staples sector's earnings share has had its ups and downs over the years, but is at its lowest point over the last 20 years at 6.6%. Its shares have followed suit, and the sector's capitalization share has declined to 6.7% (*Fig. 5*).

(3) *Sideways action*. Some sectors' earnings contribution to total S&P 500 earnings has grown—or shrunk—during various periods over the past 30 years but ended up largely unchanged over the span. For example, the Consumer Discretionary sector's earnings contributed roughly 15% of the S&P 500's earnings in the mid-1990s and as little as 4% in March 2009. But right now, its contribution stands at 10.7%, roughly where it has stood most of the time over the past two decades (*Fig. 6*). That earnings contribution is less than its 13.2% market capitalization share, perhaps because the sector includes Amazon and Netflix.

Likewise, the earnings kicked in by the Financials sector has been as low as 5% of the S&P 500's earnings in 1985 and almost as high as 30% in 2001. Now it's 18.6%, close to the middle point. Its earnings contribution is about four percentage points higher than its market capitalization, but is the norm over most historical periods (*Fig. 7*). In the late 1990s, the Materials sector contributed about 9% of the S&P 500's earnings, but that shrank sharply until 2001 and stayed low through today, at a current 2.8%. Its market capitalization share is 2.6% (*Fig. 8*).

Real Estate: Finding Some Buyers. The S&P 500 Real Estate sector stock price index is down 4.4% ytd through Tuesday's close, making it the fourth worst performing of the 11 S&P 500 sectors (*Fig. 9*). Here's how the sectors stack up ytd: Technology (13.6%), Consumer Discretionary (13.3), Energy (3.5), S&P 500 (3.3), Health Care (2.7), Financials (-2.0), Materials (-3.2), Industrials (-3.4), Real Estate (-4.4), Utilities (-4.7), Consumer Staples (-10.6), and Telecom Services (-11.9).

The industries dragging the Real Estate sector into negative territory include: Health Care REITs (-9.9%), Retail REITs (-7.8), Office REITs (-6.1), Residential REITs (-4.6), Specialized REITs (-3.4), and Industrial REITs (-0.3). Only two industries in the sector are in positive territory: Real Estate Services (12.5) and Hotel & Resort REITs (6.4) (*Fig. 10*). The drop in real estate stocks left the average REIT trading roughly 7% below the value of its underlying real-estate holdings, compared to the 2.3% premium these investments have averaged since 1990, a 6/18 *WSJ* article reported.

Investors who once turned to the Real Estate sector for yield can now get almost as much from a 10-year US Treasury note. As a result, "fund managers who actively manage their portfolios have already cut exposure to the real-estate sector to a six-month low," the above-mentioned *WSJ* article reported, citing a Bank of America Merrill Lynch report.

Is it time to go shopping? Well, some of the industry's largest players are snapping up REITs of all varieties, often at prices below net asset value. Here's a quick look at some recent transactions:

(1) *Student housing*. Greystar Real Estate Partners is in discussions to buy Education Realty Trust, a student housing owner, for about $3.1 billion, a 6/13 *WSJ* article reported. Greystar manages more than 400,000 apartment units in the US and abroad, and Education Realty owns and manages facilities at 50 universities across 25 states that offer more than 42,300 beds, both on-campus and off-campus. This would make deal number two for Greystar, which purchased apartment REIT Monogram Residential Trust with partners last September.

(2) *Swapping hotels.* Blackstone Group will purchase for $4.8 billion, including debt, LaSalle Hotel Properties, a REIT that owns 41 luxury hotels that are operated by other hotel companies. The offer for $33.50 a share will be paid in cash and represented a 35% premium to the company's share price of $22.84 before deal talk hit the market and a 13% premium to the analysts' consensus net asset value of $29.64 per share. The deal follows Blackstone's exit from another hotel investment, Hilton Worldwide

Holdings, which went public this year.

(3) *Gone shopping.* In May, France's Unibail-Rodamco acquired Westfield, a shopping mall REIT, for $24.7 billion. Together, they'll create the world's second-largest mall owner as measured by market value. The deal extends Unibail-Rodamco into the US and London, where Westfield developed properties like New York City's World Trade Center and Century City in Los Angeles. In total, Westfield owned 35 shopping centers across the US and the UK. Press reports put the capitalization rate for the deal at around 4% to 5%. The "cap rate" is the properties' annual income compared to its original cost.

In addition, Brookfield Property Partners bought the 66% stake of GGP it didn't already own at $23.50 a share. A 3/27 article in the *WSJ* reported at the time of the deal that the price was below expectations. "In a research report Tuesday, analysts at BTIG pointed out that Brookfield's 'wholly inadequate' offer values GGP at a 21.9% discount to what the company would be worth if its properties were sold separately. 'Why should the shareholders gift that arbitrage to Brookfield and award a very valuable management fee stream to Brookfield Asset Management shareholders in the process?' the report asked rhetorically. But others noted that at this juncture, the shareholders of the REIT have little choice since there are no other bids." The cap rate for the deal was reported to be 6.0%.

(4) *Deals for industrial properties too*. Prologis, the world's largest owner of distribution centers and logistics properties, agreed in April to buy DCT Industrial Trust for $8.4 billion including debt. DCT is a REIT that owns industrial properties. The deal valued DCT shares at $67.91, a 16% premium over DCT's share price before the deal's announcement.

The demand for these properties has risen along with online shopping volumes, a 4/29 *WSJ* article reported. "Rental rates in industrial real-estate markets have been growing at a more-than-5% annual rate in each of the past seven quarters, as demand outpaces supply, according to real-estate broker CBRE Inc. The firm said the 7.3% availability rate for warehouse space in the U.S. in the first quarter was the lowest in 17 years."

Entertainment: Oprah and Red Bull. Last week's 6/14 *Morning Briefing* looked at the entertainment industry and noted that Netflix was unique not just because of its delivery but because the fantastic content that it's creating sets it apart from traditional television show creators. The point that media is moving away from the traditional fare and toward new types of entertainment again was driven home recently by two very different news reports. The first involves Oprah, the second Red Bull:

(1) *An aha moment*. Apple announced a "unique, multi-year content partnership" with Oprah Winfrey. She'll create original programs for the tech giant in addition to maintaining her minority interest in the Oprah Winfrey Network and continuing her role as a contributor to CBS's *60 Minutes*.

"Apple's Winfrey announcement follows similar announcements about video projects involving Jennifer Aniston, Reese Witherspoon, Steven Spielberg, and other well-known creators and brands, all engineered by Jamie Erlicht and Zack Van Amburg, the former Sony executives Apple hired to reboot its original content plans last year," according to a 6/15 article on Recode.

What's notable is what Apple hasn't done: It hasn't purchased an existing media company.

(2) *The eyeballs are on videogames.* Along the same lines, when energy drinks company Red Bull announced a new endorsement this week, it didn't choose an actor or advertise on a popular TV show. It didn't even pick a sports celebrity. It chose Tyler "Ninja" Blevins, who graced the 3/8 *Morning Briefing,* which discussed his amazing popularity among gamers addicted to Fortnite.

Since then, the game's popularity has only grown. Fortnite represented more than a third of streaming video game views globally in May, up from only 2% in February, according to a 6/13 Recode article. Streaming isn't even available on Android phones yet, so views have room to jump higher. Already, Fortnite is the fourth-most-downloaded iOS app in the US and brings in more in-app revenue than Pokemon Go or HBO Now.

"Hundreds of millions of people watch competitive gaming, known as eSports, and in the U.S. already outnumber NHL viewers, according to a March report by Bernstein Research. By 2020, eSports is expected to be the second-most-watched sport after the NFL," the article states.

So when Red Bull went looking for a pitchman, it opted to endorse Blevins. It's also sponsoring an all-night Fortnite tournament in Chicago's Willis Tower, which will be streamed on Blevins' Twitch channel. (Remember that Twitch is owned by Amazon.) "Red Bull Rise Till Dawn, taking place on the building's 99th floor, will start as soon as the sun sets on July 21 and continue throughout the night as teams of two battle to accumulate the most points possible before the sun rises over Lake Michigan," reported a 6/18 article on Esports Observer. "The tournament ... quickly sold out, further proving the sort of weight Blevins has as an influencer and content creator."

Up next: the 2019 Fortnite World Cup, which will boast $100 million of prize money. Qualifying events begin this fall. So when your teen seems to be spending an exorbitant amount of time playing video games this summer, maybe you should look the other way?

CALENDARS

US. Thurs: Leading Indicators 0.3%, Jobless Claims 220k, Philadelphia Fed Manufacturing Index 28.0, FHFA House Price Index 0.5%, Weekly Consumer Comfort Index, EIA Natural Gas Report, Fed Releases Result of 2018 Bank Stress Test. **Fri:** C-PMI, M-PMI, and NM-PMI Flash Estimates 56.3/56.5/56.2, Baker-Hughes Rig Count. (*Wall Street Journal* estimates)

Global. Thurs: Eurozone Consumer Confidence 0.0, Japan CPI Headline, Core, and Core-Core 0.6%/0.7%/0.3% y/y, BOE Bank Rate 0.50%, BOE Asset Purchase Target & Corporate Bond Target £435b/£10b, Carney. **Fri:** Eurozone, Germany, and France C-PMI Flash Estimates 53.9/53.3/54.2, Eurozone, Germany, and France M-PMI Flash Estimates 55.0/56.2/54.0, Eurozone, Germany, and France NM-PMI Flash Estimates 53.8/52.2/54.3, France GDP 0.2%m/m/2.2%y/y, Canada Retail Sales 0.0%m/m/2.6%y/y, Canada Headline & Core CPI 2.6%/2.0% y/y, Japan NM-PMI Flash Estimate, OPEC Ministers & Partners Meet in Vienna to Discuss Outputs. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): Our Bull/Bear Ratio (BBR) slipped back below 3.00 this week, after moving back above last week for the first time in three months. Our BBR declined to 2.95 this week, following a five-week climb from 2.09 (lowest reading since November 2016) to 3.12. Bullish sentiment fell to 52.0% this week after rising 12.4ppts the previous five weeks, to a 12-week high of 55.5%, while the correction count rose to 30.4% after falling 9.6ppts the prior five weeks from 36.3% to 26.7%. Bearish sentiment ticked down from 17.8% to 17.6% this week—the lowest since the last week of March; seven weeks ago, it was at 20.8%, which was the most bears since last November. The AAII Ratio advanced for the second week last week to 67.4% after falling the prior two weeks from 64.1% to 57.1%. Bullish sentiment rose for the fifth time in six weeks, from 28.4% to 44.8% over the period, while bearish sentiment fell to 21.7% after increasing the previous three weeks, from 20.6% from 26.7%.

AC World ex-US MSCI (*link*): This index is down 4.9% ytd in dollar terms after rising 24.1% in 2017 and 1.7% in 2016. In local-currency terms, the index is down 2.3% ytd compared to gains of 15.3% and 4.1% for all of 2017 and 2016, respectively. Local-currency forward revenues has risen 13.1% from a five-year low in March 2016 to record highs since May for the first time since October 2014. Local-currency forward earnings has performed better, with a 32.1% rise from its six-year low in March 2016 to record highs since April for the first time since its prior September 2008 record. Revenues are expected to rise 5.9% in 2018 following an 8.8% gain in 2017, and earnings are expected to rise 9.8% (2018) after surging 21.7% (2017). Analysts are forecasting STRG of 5.3%, up from 5.1% a month ago. Their STRG forecast compares to a seven-year high of 6.8% in March 2017 and is up from a cyclical low of 2.3% in March 2016. Their STEG forecast of 9.2% is up from 8.6% a month earlier and compares to a four-year-high forecast of 14.1% in March 2017 and a seven-year low forecast of 6.3% in January 2016. The implied profit margin is expected to rise to 8.1% in 2018 from 7.8% in 2017. The forward profit margin forecast of 8.3% is at a nine-year high now. NERI was negative in June for a third straight month following six positive readings, but was steady at a 20-month low of -2.3%. That compares to a 76-month high of 2.7% in May 2017 and a 51-month low of -11.3% in March 2016. The P/E of 13.4 is up from a 25-month low of 13.1 in early April. That compares to a recent 31-month high of 14.8 in January, a six-year high of 15.3 in April 2015, and a bottom of 12.4 in February 2016. The index's current 11% discount to the World P/E remains close to its record-low 13% discount during March 2017.

EMU MSCI (*link*): The EMU's MSCI price index has dropped 4.4% ytd in dollar terms after rising 25.3% in 2017 and falling 1.2% in 2016. In euro terms, the price index is down 0.8% ytd following gains of 10.2% in 2017 and 1.8% in 2016. Euro-based forward revenues is 3.7% above its six-year low in May 2016, but has stalled around its prior cyclical high from August 2015 and remains 7.3% below its record high (September 2008). Euro-based forward earnings had stalled from 2011 to 2016, but reached its highest level since December 2008 during June. Although it has improved 21.8% from its 23-month low in June 2016, it remains 17.8% below its record high in January 2008. Analysts expect revenues to rise 2.8% in 2018 after a 5.0% gain in 2017, and think earnings will rise 7.5% (2018) following a 13.1% increase in 2017. Forecasted STRG of 3.1% is up m/m from 2.9%, which compares to a six-year high of 5.0% in April 2017 and a cyclical low of 2.0% in May 2016. Forecasted STEG of 8.4% is up m/m from 7.7%, which compares to a 78-month high forecast of 21.0% during February 2017 and a seven-year low of 5.7% in April 2016. STEG had been higher than LTEG (currently 10.8%) from July 2016 to May 2017, but is trailing now. The forward profit margin rose m/m to a nine-year high of 7.9% from 7.7%, which is up from a cyclical bottom of 6.2% in May 2013. The implied profit margin is expected to improve to 7.6% in 2018 from 7.3% in 2017. NERI was negative in May for a tenth month, but improved to -2.1% from a 21-month low of -5.0%. That reading is down from an 11-year high of 8.1% in May 2017 and compares to a 24-month low of -13.2% in April 2016. The P/E of 13.6 is up from a 23-month low of 23.5 in March, but down from a nine-month high of 14.9 in January. That compares to a 13-year high of 16.4 in April 2015 and a 30-month low of 12.2 in February 2016. The current valuation represents a 9% discount to the World MSCI's P/E now, up from an 11% discount in March and a record-low 25% discount during 2011. But the current reading is still well below the 1% premium during April 2015—the post-euro-inception record high.

Emerging Markets MSCI (*link*): The EM MSCI price index is down 6.3% ytd in US dollar terms after surging 34.3% in 2017 and rising 8.6% in 2016. In local-currency terms, EM has slipped 2.7% ytd compared to gains of 27.8% (2017) and 7.1% (2016). Local-currency forward revenues is up 19.6% from a four-year low in June 2016 and at a record high in June for the first time since November 2014. Local-currency forward earnings has fared substantially better, rising to record highs since September for the first time since January 2014; it has improved 40.1% from April 2016's six-year low. Revenues are expected to rise 9.9% in 2018, down from a 12.2% gain in 2017. That's expected to lead to an earnings gain of 15.9% in 2018, which follows a 22.3% surge in 2017. Forecasted STRG improved to

8.8% in June from 8.6% in May, but is down from a four-year high of 9.6% in January 2017. STEG rose to 13.7% from 13.4%, which is down from a cyclical peak of 17.5% in March 2017 and is below LTEG (17.7%) again. The implied profit margin is expected to improve to 7.1% in 2018 from 6.7% last year. The forward profit margin edged down 0.1ppt m/m to 7.2% from a six-year high in May, but remains 3.1ppts below its 10.3% record high in December 2007 and compares to a record low of 6.0% in February 2016. NERI was negative for a fourth month in June as it weakened to a 24-month low of -3.8%. NERI had been positive for only three months through January after 80 months of negative readings through October, and compares to an 83-month low of -10.2% in March 2016. Emerging Markets' valuation had been more stable recently than that of the rest of the world, but fell to a 23-month low of 11.8 and is down from an eight-year high of 13.1 in January. The index is trading at a 22% discount to the World MSCI P/E, remaining near its best reading in 16 months, and compares to a 10-year-low 30% discount in August 2016.

MSCI World & Region Net Earnings Revisions (*link*): Analysts' recent earnings revisions through June point toward waning optimism about profits across the emerging market regions and the US, but the EMU and Europe had their NERI readings improve m/m for a second straight month. Powered by the US, in the lead among regions, the AC World MSCI's NERI was positive for a 17th month, but weakened to a nine-month low of 1.2% in June from 1.5% in May and is down from a 93-month high of 7.1% in February. The US was positive for a 14th straight month as its NERI fell to 9.2% from 10.3% in May and from a record high of 21.8% in March. All other regions had negative NERIs during June as EM Eastern Europe fell to a 26-month low and EM Asia to a 24-month low. June's scores among the regional MSCIs: US (9.2% in June, down from 9.3% in May), AC World (1.2, 1.5), EM Eastern Europe (-0.6 [26-month low, -0.1), EAFE (-1.1, -1.7 [20-month low]), Europe ex-UK (-1.3, -2.7), Europe (-1.3, -2.8), EM Latin America (-1.6, -1.2), EMU (-2.1, -3.5), AC World ex-US (-2.3 [20-month low], -2.3), Emerging Markets (-3.8 [24-month low], -3.3), and EM Asia (-4.1 [24-month low], -3.7).

MSCI Countries Net Earnings Revisions (*link*): NERI was positive for 18/44 MSCI countries in June, up from 17/44 in May, which was the lowest count since October 2017. NERI improved m/m in June for 26/44 countries, up from 18/44 countries in May and 6/44 in April, which was the fewest since December 2008. Among the countries with improving NERI in June, the Czech Republic's was the highest since December 2005 (a 150-month high), followed by Chile's (100-month high or since March 2010), Italy's (13-month high), Sweden's (12), and Spain's (11). On the flip side, Indonesia's was at a 31-month low, followed by those of Belgium (30), Canada (20), Japan (20), Malaysia (20), and China (17). China's 22-month positive NERI streak is the best among countries, followed by the positive streaks of Hong Kong (20), Turkey (20), the Czech Republic (13), and Switzerland (12). South Africa's NERI has been negative for 49 straight months, followed by the negative streaks of New Zealand (25), Mexico (20), Pakistan (19), Israel (15), and the United Kingdom (13). NERI turned positive in June for three countries that had been briefly negative during April or May: Austria, Australia, and Norway. Two countries slipped back into negative territory this month; among them, Brazil was negative for the first time in eight months and Egypt for the first time in four months. The highest NERI readings in June: the Czech Republic (10.5%), US (9.2), Italy (6.7), Sweden (6.5), Russia (6.1), Hungary (4.8), Turkey (3.8), Hong Kong (3.6), and Chile (3.5). The weakest NERIs occurred this month in Pakistan (-12.5), Ireland (-12.1), Indonesia (31-month low of -11.3), Greece (-9.6), Malaysia (20-month low of -9.3), Denmark (-9.1), and the Philippines (-9.0).

US ECONOMIC INDICATORS

Existing Home Sales (*link*): Existing home sales retreated for the second month in May, after a two-month spurt, with closings down in a majority of the country. NAR's chief economist noted, "Incredibly low supply continues to be the primary impediment to more sales, but there's no question the combination of higher prices and mortgage rates are pinching the budgets of prospective buyers, and ultimately keeping some from reaching the market." Existing home sales—tabulated when a purchase contract closes—fell -0.4% to 5.43mu (saar) after a revised -2.7% decline in April, which was slightly steeper than the -2.5% initial estimate. Regionally, only the Northeast showed an increase in sales in May. Here's a tally of the monthly and yearly changes: Northeast (4.6%m/m & -11.7%y/y), Midwest (-2.3 & -2.3), West (-0.8 & -4.1), and South (-0.4 & 0.0). Single-family sales fell 3.6% during the two months ending May to 4.81mu (saar), while multi-family sales climbed two of the past three months by a total of 6.9% to 620,000 units (saar). The number of existing single-family homes on the market at the end of May climbed for the fifth month, from 1.29mu to 1.65mu over the period. Still, inventory was 5.2% below a year ago—recording y/y declines for the 36th consecutive month though narrowing from double-digit declines at the end of last year. Unsold inventory was at a 4.1 months' supply, rising steadily from December's record low of 3.1 months. The median existing single-family home price was $267,500 in May, up 5.2%.

GLOBAL ECONOMIC INDICATORS

European Car Sales (*link*): In May, EU passenger car registrations (a proxy for sales) flattened out after robust growth in April. Registrations were only 0.8% above a year ago, after a 9.6% y/y jump in April. Results were mixed among major EU markets: Sales in Spain (7.2% y/y) and the UK (3.4) were higher than a year ago, while sales in Germany (-5.8) and Italy (-2.8) were below a year ago. Looking at the ytd growth rate, sales were up 2.4% y/y, largely sustained by a strong double-digit gain in sales by the new EU member states (11.6). Among the major markets, Spain (10.6) was the best performer, followed by France (3.5) and Germany (2.6); sales continued to contract on a ytd basis in the UK (-6.8).

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