



MORNING BRIEFING

June 27, 2018

Grazing Bulls

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

(1) Buybacks booming. (2) A corporate finance model explaining buybacks. (3) S&P 500 buybacks + dividends = \$6.9 trillion since start of bull run. (4) Beware of fake news on trade. (5) No sign of global slowdown in S&P 500 forward revenues. (6) Forward earnings at yet another record high. (7) Animal spirits remain animated. (8) Four regional Fed surveys upbeat in June. (9) CEOs remain upbeat. (10) Small business owners say best outlook for expansion on record. (11) Mirror, mirror on the wall: Is the US the fairest trader of them all? (12) Aluminum and steel tariffs aren't negotiable since they are a matter of national security. (13) Not just about tariffs. (14) A correction on Google's P/E.

Strategy I: Buyback Bonanza. As Joe reports below, S&P 500 buybacks are back. Actually, they never left the current bull market despite recurring chatter that the buyback binge was over. Since 2014, they've fluctuated around an annualized rate of roughly \$550 billion ([Fig. 1](#)). They jumped during Q1-2018 to an annualized \$756 billion. That's a record high, exceeding the previous record high of \$688 billion during Q3-2007.

Obviously, buyback activity was boosted by repatriated earnings following the passage of the Tax Cuts and Jobs Act at the end of last year. It lowered the corporate tax rate on such earnings from the 35.0% statutory rate to a one-time mandatory tax of 15.5% for liquid assets and 8.0% for illiquid assets payable over eight years. Odds are that corporations will continue to buy back their shares at a solid pace through the end of this year, though not at the record set during Q1.

I've often argued during the current bull market that the Fed's Stock Valuation Model makes more sense to explain corporate buyback decisions than it does to explain investors' stocks-vs-bonds asset allocation decisions ([Fig. 2](#)). As I explain in Chapter 14 of [Predicting the Markets](#):

"[C]orporate finance managers have a big incentive to buy back their companies' shares when the forward earnings of their corporations exceeds the after-tax cost of borrowing funds in the bond market. Using the pretax corporate bond yield composite overstates the after-tax cost of money borrowed in the bond market. The spread between the forward earnings yield and the pretax cost of funds did widen after 2004 and remained wide well into the next decade. Obviously, it did the same on an after-tax basis. ... The bottom line is that as corporate managers have increased their buyback activities, their version of the Fed's Model has probably had more weight in the valuation of stocks. In theory, this means that valuation should be determined by the corporate version of the model."

Meanwhile, S&P 500 dividends set a record high of \$436 billion (annualized) during Q4-2017 and remained there during Q1 of this year. Together, trailing four-quarter buybacks and dividends jumped to \$1.0 trillion during Q1 ([Fig. 3](#)). Since the start of the bull market during Q1-2009, buybacks have totaled \$4.1 trillion, while dividends totaled \$2.8 trillion. The grand total has been \$6.9 trillion, so far!

Strategy II: Bullish Earnings. While the bull market stopped charging ahead ever since the 1/26

record high, it continues to zigzag in record-high territory. The bears can continue growling about a potential trade war. Meanwhile, the bulls are taking a break and grazing on share buybacks and record corporate earnings. On Monday, the bearish noise about trade protectionism drowned out the bullish signals coming from earnings. It turns out that some of the noise might have been based on fake news, as discussed below.

For some peace and quiet, let's sing "[Home on the Range](#)." Here are a few of the song's memorable lyrics: "Oh give me a home where the buffalo roam / Where the deer and the antelope play / Where seldom is heard a discouraging word / And the skies are not cloudy all day." More specifically:

(1) *Revenues*. S&P 500/400/600 industry analysts report that the global skies remain sunny. They continued to raise their estimates for 2018, 2019, and forward revenues to new record highs during the 6/14 week ([Fig. 4](#)).

(2) *Earnings*. As a result, their comparable estimates for earnings are also rising in record-high territory ([Fig. 5](#)). S&P 500 forward earnings rose to \$168.56 per share during the 6/21 week, rapidly approaching our \$170 target for year-end. Barring a trade war, that number should easily be achieved. Now multiply it by forward P/Es of 14, 16, and 18 to get the year-end S&P 500 potential levels of 2390, 2720, or 3060. Take your pick. We pick 3100. Again, that's barring a trade war.

(3) *Profit margins*. Forward earnings is rising faster than forward revenues for the S&P 500, as evidenced by the new record high of 12.2% for the forward profit margin set in mid-June ([Fig. 6](#)).

US Economy: Animal Spirits Update. While we are on the subject of bulls, buffalo, deer, and antelope, let's discuss animal spirits, which were dramatically boosted following the election of Trump on November 8, 2016. Notwithstanding all of Trump's trade war talk, the animal spirits remain bullishly animated. Here are a few examples:

(1) *Regional business confidence*. As Debbie reports below, June's Fed district business surveys are now available for New York, Philadelphia, Dallas, and Richmond. The average composite index rose to one of its best readings on record. The comparable orders index held near its best level since the mid-2000s, while the employment index recorded its best showing in the history of the series going back to 2004 ([Fig. 7](#)).

(2) *Business confidence*. The CEO Outlook Index compiled by the Business Roundtable edged down during Q2 to 111.1, but remained near Q1's record high of 118.6 ([Fig. 8](#)). It remains bullish for capital-spending growth. May's NFIB small business survey found that the outlook for expansion was the highest on record ([Fig. 9](#)).

Trade I: Fair and Unfair Trade. The Trump administration is aggressively pushing to make free trade fairer trade. President Trump is doing so on a bilateral basis as opposed to the traditional multilateral approach. It's easier to spot and call out unfair traders in a bilateral than a multilateral system, so it really is the best way to make sure that free trade remains fair on a reciprocal basis. To get his way, Trump has been imposing—and threatening to impose—tariffs on US trading partners that don't play fair in his view. The question is whether Trump's complaints are valid.

A 3/8 [article](#) in *The Washington Post* attempted to answer this question. The article, titled "Trump's trade war: Does the U.S. have the 'lowest tariffs in the world'?", claimed that White House officials' contention that US has the lowest tariffs around the world is inaccurate. In fact, the US does not impose the very lowest tariffs across the board. However, US tariffs, on average, are lower than those imposed by our major trading partners. I asked Melissa to find analyses that have attempted to slice and dice the

relevant data:

(1) *Wilbur's data.* To support the administration's claims, Peter Navarro, director of the White House National Trade Council, provided a chart to *The Washington Post* comparing the average applied tariffs for the US, the European Union (EU), and China. It first appeared in a 2017 *WSJ* opinion [piece](#) by Wilbur Ross, US secretary of Commerce.

The numbers come from a 2017 World Trade Organization [report](#) containing comprehensive global data on tariffs for 2016. Ross observes: "As the nearby chart shows, China's tariffs are higher than those of the U.S. in 20 of the 22 major categories of goods. Europe imposes higher tariffs than the U.S. in 17 of 22 categories."

(2) *Micro vs macro data.* *The Washington Post* article contended that the categories included in the chart (such as "dairy," "clothing," and "electrical machinery") are too broad, masking higher tariffs within the categories like the US's 25.0% tariff on tuna. In our opinion, *The Washington Post's* take may be too micro. The tariffs on items within the categories in Ross' chart appropriately seem to balance each other out. To elaborate on the tuna example, US tariffs on "fish and fish products" is just 0.8% despite the 25.0% tariff on tuna, and 0.8% is miniscule compared to the EU's 12.0% and China's 10.6% averages for the category.

On the other hand, the article presented World Bank [data](#) including the simple mean and weighted average of applied tariffs by country overall. That seems too broad to be meaningful. The chart shown by Ross seems to be the appropriate level of detail—i.e., not too micro or too macro—supporting the view that US trading partners often play unfairly when it comes to tariffs.

Trade II: Not Just About Tariffs. Tariffs have been a big focus recently in the media. However, Trump's unfair-trade complaints are about more than tariffs. Several critical reports serve as the basis for the administration's recent actions and threats on trade. Each report goes well beyond the tariff issue, as follows:

(1) *National security.* On February 16, the US Department of Commerce released Section 232 [reports](#) on steel and aluminum. Commerce found that the quantities and circumstances of steel and aluminum imports "threaten to impair the national security," as defined by Section 232. So the administration imposed steel and aluminum tariffs not to counter pre-existing tariff barriers imposed by our trading partners but rather to stimulate greater domestic capacity expansion as a matter of national security. In other words, the tariffs on steel and aluminum likely are here to stay.

It's notable that as of 2015, Canada was the largest exporter of steel to the US, and Germany was in the top 10. (See Figure 14 in the steel report.) So Trump isn't necessarily going after US allies, but rather aiming to bring the production of steel back home. During a press conference yesterday, Trump further supported that claim, stressing that lots of US steel companies are planning to expand for the first time in years. The President [denigrated](#) Harley Davidson's recently announced plan to boost overseas production to circumvent the EU's retaliatory tariffs.

(2) *Foreign trade barriers.* In March, the Office of the United States Trade Representative (USTR) issued its annual [report](#) on "Foreign Trade Barriers." It includes a discussion of both tariff and non-tariff barriers to trade. Non-tariff barriers are extremely difficult to quantify, according to the report.

The USTR classifies foreign trade barriers into ten different categories, and "tariffs" is not one of them. Instead, tariffs are included in the category "import policies," which covers "other import charges, quantitative restrictions, import licensing, customs barriers, and other market access barriers." The list

of China's trade barriers is too long to cover here; the report also includes lengthy lists for the EU and Canada, among other countries.

(3) *Technology interests*. On March 22, the USTR released a Section 301 [report](#) on China's unfair trade practices related to technology transfer, intellectual property, and innovation. The key finding is that China has set a goal of dominating global technology in a way that negatively affects American economic interests. Many of China's unfair technology trade practices go well beyond tariffs, as we detailed in our [3/26](#), [3/27](#), [3/29](#), and [4/5 Morning Briefings](#).

A chronology of the US-China trade spat recapped in our [6/20 Morning Briefing](#) included the 6/15 release of a White House list of possible tariffs on categories of goods aimed at Chinese strategic plans to dominate high-technology industries. In response to that US threat, China threatened to retaliate, and the US further countered with more potential incremental tariffs. We had noted in that commentary that escalating tariff threats might lead to actions beyond tariffs.

On Monday, the *WSJ* and *Bloomberg* reported based on supposedly faulty sources that future US actions may include restrictions on China's investment in US technology companies. After those reports sent US stocks lower, Secretary of the Treasury Steven Mnuchin discredited the news in a [tweet](#). Peter Navarro ignited a late-day rebound in stocks when he [clarified](#) that there were no immediate plans to implement such restrictions. But he did say that the US Treasury Department soon would be discussing related matters with Trump. White House Press Secretary Sarah Huckabee Sanders had the last word on the matter (so far), saying that soon "a statement will go out that targets all countries that are trying to steal our technology." We will not be surprised if the Trump administration soon threatens more non-tariff barriers to trade.

Correction. We made a mistake in yesterday's *Morning Briefing*. Google (a.k.a. Alphabet) stock isn't selling at a forward P/E of 59.0. The correct number is 27.4.

CALENDARS

US. Wed: Durable Goods Orders, Total, Ex Transportation, and Core Capital Goods -0.4%/0.4%/0.2%, Advanced Merchandise Trade Balance -\$69.0b, Pending Home Sales 0.7%, MBA Mortgage Applications, EIA Petroleum Status Report, Rosengren. **Thurs:** Real GDP & PCE 2.2%/1.0%, GDP Price Index 1.9%, Corporate Profits, Jobless Claims 220k, Kansas City Fed Manufacturing Index, Weekly Consumer Comfort Index, EIA Natural Gas Report, Fed Releases Part 2 of Annual Bank Stress Test, Bullard. (*Wall Street Journal* estimates)

Global. Wed: China Industrial Profits, Carney, Poloz. **Thurs:** Eurozone Economic Confidence 112.0, Germany CPI 0.2%*m/m*/2.2%*y/y*, Germany Gfk Consumer Confidence 10.6, UK Gfk Consumer Confidence -7, Japan Jobless Rate 2.5%, Japan Industrial Production -1.0%*m/m*/3.4%*y/y*, ECB Publishes Economic Bulletin. (DailyFX estimates)

STRATEGY INDICATORS

YRI Weekly Leading Index ([link](#)): After three straight weeks of falling from a record high followed by a week of rebounding, the June 16 week found our Weekly Leading Index (WLI)—a good coincident indicator that can confirm or raise doubts about stock market swings—rebounding for the second week. Our WLI, which is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI), jumped 2.1% during the two weeks ending June 16—to within 1.5% of its record high—after contracting 3.6% the previous three weeks. Our BBB rebounded 2.9% over the two-week period, after a three-week slide of 5.6%; it's within 3.2% of its record high. Jobless claims—one of the

components of our BBB—fell from 225,500 to 221,000 (4-wa) the past two weeks, heading back toward its recent low of 213,500 five weeks ago—which was the lowest reading since December 13, 1969. Meanwhile, the CRB raw industrial spot price index, another BBB component, has reversed recent gains. The WCCI climbed 3.1% the past two weeks after falling five of the previous seven weeks, by a total of 5.7%, from its cyclical high.

S&P 500 Buybacks ([link](#)): S&P 500 quarterly buybacks soared 38.0% q/q to \$189.1 billion during Q1-2018, and was up 42.0% y/y. The \$137.0 billion reading highest quarterly buyback amount on record, dating back 81 quarters to Q1-1998, and exceeded the prior record high of Q3-2007 by 9.9%. Furthermore, the quarterly buyback amount improved q/q for a third consecutive quarter for the first time since Q1-2014. The four-quarter buybacks sum jumped 10.8% q/q to a seven-quarter high of \$575.3 billion from \$519.4 billion. However, the four-quarter sum remains 2.4% below Q1-2016's record high of \$589.4 billion, which at the time was its first since Q4-2007. S&P 500 buybacks in Q1 accounted for 0.84% of the total market capitalization for the S&P 500, the highest in eight quarters and up from 0.60% during Q4, which was the lowest since Q1-2010. That compares to a cyclical peak of 1.15% in Q3-2011 and a record high of 1.28% during Q3-2007.

S&P 500 Sectors Buybacks ([link](#)): Buybacks rose q/q during Q1-2018 for seven of the 11 sectors and fell for four. That compares to six rising and five falling during Q4-2017. The biggest q/q buyback gainers on a percentage basis in Q4-2017: Telecom (up 1,788.9% q/q to a four-quarter high of \$170 million from \$9 million), Utilities (981.2%, to an eight-quarter high of \$179 million from \$17 million), Health Care (125.3%, to a record high of \$35.6 billion from \$15.8 billion), Energy (94.4%, to a 13-quarter high of \$10.1 billion from \$5.2 billion), Tech (77.1%, to a record high of \$63.4 billion from \$35.8 billion), Industrials (43.8%, to a seven-quarter high of \$16.6 billion from \$11.6 billion), and Materials (10.4%, to a five-quarter high of \$2.3 billion from \$2.1 billion). The biggest percentage q/q decliners: Real Estate (-32.8%, to \$1.3 billion from \$806 million), Consumer Staples (-30.8%, to a 34-quarter low of \$7.3 billion from \$10.5 billion), Consumer Discretionary (-10.1%, to \$18.7 billion from \$20.8 billion), and Financials (-0.3%, to \$33.8 billion from \$33.9 billion). Tech accounted for the biggest portion of total S&P 500 buybacks in Q1-2018 for a second straight quarter, improving to a record-high 33.5% share from 26.1% in Q4. Tech had held the top spot for 16 straight quarters through Q3-2016, but since has traded places with Financials and Health Care. Health Care's share was second, as it rose to 18.8% in Q1 from 11.5% in Q4, and Financials' share was a close third, dropping to 17.9% in Q1 from 24.8% in Q4. Consumer Discretionary's was fourth (down to 9.9% from 15.2%), and Industrials' was fifth (up to 8.8% from 8.4%).

S&P 500 Cash Return & Buyback Yield ([link](#)): During Q1-2018, the S&P 500 companies continued their long-established trend of spending more on buybacks than dividends, as buybacks of \$189.1 billion outpaced the near-record-high quarterly dividend payment of \$109.0 billion. Buybacks have exceeded dividends in 41 of the past 46 quarters, except during the financial crisis from Q4-2008 to Q4-2009, when all sectors cut buyback spending drastically. With the pace of buybacks and dividends rising in Q1, the four-quarter sum of buybacks and dividends, or cash returned to investors, improved for a third straight quarter to a record high of \$1 trillion from \$938.3 billion during Q4. The cash return rose 6.9% q/q and is up 10.6% from a nine-quarter low of \$906.7 billion during Q2-2017. It exceeded the prior record high of \$974.6 billion in Q1-2016 by 2.9%. On a brighter note, companies earned more than they paid out to investors for a sixth straight quarter after six straight quarters of earning less. More specifically, Q1-2018's four-quarter sum of operating earnings, at a record-high \$1.129 trillion, exceeded the \$1.003 trillion returned to investors. The cash return was 11.2% lower than trailing-four-quarter operating earnings during Q1, little changed from 12.0% during Q4, which was the best coverage ratio since Q3-2014. The S&P 500's Q1 figures are much better on an ex-Energy basis. Operating earnings exceeded the cash return for a sixth straight quarter as the percentage edged up to 86.8% from 86.1%, which was the lowest since Q4-2013 and compares to a 28-quarter high of 102.2%

in Q2-2016. Including Energy, the S&P 500's buyback yield improved to a five-quarter high of 2.56% from a 31-quarter low of 2.28% in Q4, and the dividend yield rose to 1.90% from a 27-quarter low of 1.84%. Adding both together, the buyback + dividend yield (or cash return) jumped to 4.46% in Q1 from a 31-quarter low of 4.11% in Q4.

S&P 500 Sectors Cash Return & Buyback Yield ([link](#)): During Q1-2018, eight of the 11 sectors had enough operating earnings on a trailing-four-quarter basis to cover their buybacks and dividends (cash returned to investors), unchanged since Q2-2017 and up from 7/10 sectors during Q1-2017. Consumer Staples failed to cover its cash return for a 13th straight quarter, and the Energy sector missed for a 12th straight quarter. However, Energy was profitable on a GAAP operating earnings basis for a fifth quarter after five quarters of losses. Industrials covered its cash return for a fourth quarter after missing for seven straight quarters, Consumer Discretionary did so for a fifth quarter after missing for 12 quarters, Materials did so for just the sixth time in the 13 quarters since Q1-2014, and Tech did so for only the seventh time over that same time period. Here's how the sectors' four-quarter cash returns relative to four-quarter earnings ranked in Q1-2018: Energy (143.4%), Real Estate (140.7), Consumer Staples (104.2), Consumer Discretionary (95.4), Financials (91.7), S&P 500 (88.1), Industrials (96.7), S&P 500 ex-Energy (86.8), Tech (81.7), Health Care (81.6), Telecommunication Services (74.6), Utilities (61.3), and Materials (59.4). Looking at the four-quarter buyback + dividend yield, the percentage returns rose q/q for all 11 sectors; here's how they ranked: Financials (5.59%), Telecom (5.47 [nine-quarter high]), Consumer Staples (5.46), Energy (4.53 [nine-quarter high]), S&P 500 (4.46), Industrials (4.38), Consumer Discretionary (4.32), Real Estate (4.12 [only the fourth quarter for which data is available]), Health Care (4.06), Tech (3.99), Utilities (3.66 [nine-quarter high]), and Materials (2.99).

US ECONOMIC INDICATORS

Consumer Confidence ([link](#)): Consumer confidence dipped this month, though remained at an elevated level. The Conference Board's overall confidence reading slipped to 126.4 from a revised 128.8 in May (from 128.0), not far from February's 130.0 reading—which was the highest since November 2000. "Consumers' assessment of present-day conditions was relatively unchanged, suggesting that the level of economic growth remains strong," said Lynn Franco, director of economic indicators. "While expectations remain high by historical standards, the modest curtailment in optimism suggests that consumers do not foresee the economy gaining much momentum in the months ahead." June's present situation component (to 161.1 from 161.2) barely budged from May's 17-year high, while the expectations component (103.2 from 107.2) remained volatile around its cyclical high. The current jobs outlook remained very favorable this month: Jobs plentiful (to 40.0% from 42.1%) held near May's cyclical high, while jobs hard to get (14.9 from 15.6) fell to its lowest percentage since July 2001. The six-month jobs outlook showed the percentage expecting more jobs (20.0%) continued to surpass those expecting fewer jobs (12.6) by one of the widest margins of the past couple of years.

Regional M-PMIs ([link](#)): Manufacturing activity was very strong this month, according to the four Fed districts that have now reported—New York, Philadelphia, Dallas, and Richmond. We average the composite, orders, and employment measures as data become available. The composite index (to 25.4 from 24.3) for June climbed toward February's 26.3—which was the best pace since July 2004. The New York (to 25.0 from 20.1) region expanded at its fastest pace since October, while growth in both the Dallas (36.5 from 26.8) and Richmond (20 from 16) regions was back up near their February cyclical highs. Meanwhile, growth in the Philadelphia (19.9 from 34.4) region slowed from May's vigorous pace, which was the fastest in a year. The new orders gauge (22.7 from 25.1) slowed, but remained near its best readings since the mid-2000s. Growth in the Philly (17.9 from 40.6) region slowed sharply from May's 45-year high, while orders in the Dallas (29.6 from 27.7), Richmond (22 from 16), and New York (21.3 from 16.0) regions accelerated. The employment measure (23.8 from 20.1)

recorded its best showing in the history of the series going back to 2004, as manufacturers in the Philly (30.4 from 30.2), Dallas (23.9 from 23.4), Richmond (22 from 18), and New York (19.0 from 8.7) regions all added to payrolls at a robust pace.

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