



MORNING BRIEFING

July 3, 2018

Animal Spirits Update

The next Morning Briefing will be sent on Monday, July 9.

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

(1) An upset victory upsets “The Resistance.” (2) Meanwhile, animal spirits remain spirited for the most part. (3) S&P 500 sectors’ performance driven more by bond yield than protectionism since Trump’s election win. (4) GDPNow back over 4.0%. (5) M-PMI remains upbeat. (6) M&A is also bullish for stocks. (7) Powell is even handed. (8) More on the corporate debt threat.

US Economy: Urge To Merge. Donald Trump revived animal spirits when he was elected POTUS on November 8, 2016. It was an upset victory, for sure. It wasn’t widely expected, and it certainly upset Hillary Clinton and other Democrats, who now refer to themselves as “The Resistance.” Nevertheless, the animal spirits remain elevated.

The S&P 500 rallied dramatically, gaining 34.3%, after Trump’s election through 2017 and until it peaked at a record 2872.87 on January 26 of this year ([Fig. 1](#)). It is down 5.1% since then through Monday’s close. The rally was driven by Trump’s championing and implementing deregulation. It was also driven by expectations of tax cuts, which were enacted late last year. The S&P 500 has been zigzagging below its record high as a result of Trump’s protectionist saber-rattling since January 22, when he imposed tariffs on imports of solar panels and washing machines ([Fig. 2](#)).

Yet despite the rising risks of a full-blown trade war, animal spirits remain animated in the US. The US economy is performing well, and the stock market has been holding up remarkably well despite mounting protectionist tensions between the US and our major trading partners. Indeed, the S&P 600 SmallCaps has been mostly zagging to new record highs ([Fig. 3](#)).

Presumably, SmallCaps are less exposed to the risks of protectionism than LargeCaps. On the other hand, we previously noted that within the S&P 500, cyclical stocks have been outperforming defensive ones since Trump’s election ([Fig. 4](#)). That runs counter to the greater exposure of the former than the latter to protectionism. It is more consistent with the backup in bond yields since Trump won on expectations that his policies would be stimulative, forcing the Fed to raise interest rates aggressively rather than gradually. Let’s review the state of animal spirits:

(1) *GDPNow forecast remains strong.* The Atlanta Fed’s [GDPNow](#) tracking model lowered the Q2 estimate below 4.0% after personal income was reported last week. It was back up to 4.1% after yesterday’s release of construction spending during May and June’s ISM survey of manufacturing purchasing managers.

(2) *Purchasing managers remain in high spirits.* June’s M-PMI remained at an elevated level of 60.2, as Debbie discusses below. The new orders (63.5), production (62.3), and employment (56.0) components were also relatively high last month ([Fig. 5](#)). This augurs well for S&P 500 revenues growth on a y/y

basis, which is highly correlated with the M-PMI ([Fig. 6](#)).

(3) *Urge to merge remains strong.* Joe and I have noted that corporations used some of their repatriated earnings to buy back their shares at a record pace during Q1. That has provided support to stocks at a time when they were pressured by Trump's protectionism, which somewhat dispirited investors in equity ETFs ([Fig. 7](#)).

Also providing support to the market is the rapid pace of M&A activity. According to Dealogic, it totaled \$532 billion during Q2 and \$1.74 trillion over the past four quarters ([Fig. 8](#)).

(4) *Joe wants us to raise our earnings forecast.* Joe and I benchmark our S&P 500 earnings-per-share forecasts to the consensus estimates of industry analysts covering the companies in this composite. We do so recognizing that the analysts tend to be too optimistic. So our estimates tend to fall below their consensus.

However, Joe alerts me that our 2018 and 2019 estimates (\$155 and \$166) may be too low relative to the analysts' highly spirited current estimates (\$161 and \$177) ([Fig. 9](#)). I agree. So we are now projecting \$158 for this year and \$169 for next year. Of course, that comes with the usual hedge clause these days, namely "barring a trade war." (See [YRI S&P 500 Earnings Forecast](#).)

The Fed: Cool Hands Powell. Last week, we learned that the Fed finally had hit its 2.0% inflation target dead-on after nearly a decade of highly accommodative monetary policy. Melissa and I doubt that the Fed's bullseye will change Fed Chairman Jerome Powell's approach to monetary policy. Since Powell began his tenure as Fed chair on February 5, he has expressed a balanced view of the US economy. Powell consistently has stressed that the Fed will continue to tighten monetary policy at a gradual pace.

The even-handed Powell once again presented his two-handed view at an ECB forum on Central Banking in a 6/20 [speech](#) titled "Monetary Policy at a Time of Uncertainty and Tight Labor Markets." Powell concluded: "Today, with the economy strong and risks to the outlook balanced, the case for continued gradual increases in the federal funds rate remains strong and broadly supported among FOMC participants." Here are a few more of the key points from his speech:

(1) *Jobs: Good, but not as good as it gets.* On one hand, Powell began with a positive note about jobs: "Today, most Americans who want jobs can find them. ... A tight labor market may also lead businesses to invest more in technology and training, which should support productivity growth." He added: "In short, there is a lot to like about low unemployment."

On the other hand, Powell expects the job market to "strengthen further." He stated: "The labor force participation rate of prime-age workers has moved up in recent years but remains below pre-crisis levels. In addition, wage growth has been moderate, consistent with low productivity growth but also an indication that the labor market is not excessively tight."

Traditionally, the Fed has relied on the Phillips curve, or the inverse relationship between inflation and unemployment, to guide policy decisions. Powell repeatedly has suggested that he questions the strength of the relationship. In his speech, he stated that "a flatter Phillips curve makes it harder to assess whether movements in inflation reflect the cyclical position of the economy or other influences." The subdued pace of wage growth despite incredibly low unemployment seems to be the key reason that Powell won't likely be quick to change his view on the Fed's future course of action.

(2) *Financial stability: Fine, but warrants watching.* On the topic of credit bubbles, as we discussed in

the section below, investors may find it comforting that Powell does “not see broad signs of excessive borrowing or leverage.” He further stated that “banks have far greater levels of capital and liquidity than before the crisis.” Powell sees US financial stability vulnerabilities as moderate. Nevertheless, he said that “the fact that the two most recent US recessions stemmed principally from financial imbalances, not high inflation, highlights the importance of closely monitoring financial conditions.”

(3) *Growth: Strong, but could be stronger.* Powell's perspective of US economic growth also has two hands. On one hand, Powell said: “Growth is meaningfully above most estimates of its long-term trend.” On the other hand, he qualified that with: “the trend is not as strong as we would like it to be.”

Credit: Big Corporate Debt Bubble? Corporate debt levels have surged to record highs. That has led to all sorts of dire warnings from the media about a credit bubble, as we discussed in our 6/19 [Morning Briefing](#). Corporations have had a huge incentive to take on more debt: It has been incredibly inexpensive to borrow for nearly a decade now. The worry is that all that debt could lead to another crisis, especially as interest rates rise, increasing the cost of refinancing maturing debt.

When corporate liquid assets are subtracted from corporate debt, the talk of a credit bubble seems less credible. However, corporations with a lot of cash could distort the net debt statistic on a macro basis. Recent data confirm this distortion for the wide universe of nonfinancial corporations (NFCs). However, larger firms included in the narrower S&P 500 universe seem to have a healthy distribution of cash relative to their debt loads.

Investors in the S&P 500 can take some solace in this. But they should keep watch for signs of trouble among the larger universe of smaller companies, which could spill over into the broader economy. Nevertheless, as discussed below, default rates for NFC borrowings are expected to remain low, at least for the near term. Let's start with the sobering news before turning to the uplifting news:

(1) *Lots of cash & debt.* According to a 6/26 [report](#) by S&P Global, total debt outstanding rose to \$6.3 trillion in 2017 for the roughly 1,900 NFC borrowers rated by the agency. Total debt has risen roughly \$2.7 trillion over the past five years. Cash as a percentage of debt is at 33% for US corporates overall, which is flat with the 2016 level. These companies reported holding \$2.1 trillion in liquid investments as of year-end 2017. That's “an increase of 9% versus 2016 and more than double the cash balances reported in 2009.”

(2) *Sobering data.* “Removing the top 25 cash holders from the equation paints a more sobering picture,” the report observed. “Speculative-grade borrowers, for example, reached a new record-low cash-to-debt ratio of just 12% in 2017, lower than the 13% reported in 2016 and even below the 14% reported in 2008 during the Great Recession.”

S&P Global sees a similar trend among highly rated borrowers: “More than 450 investment-grade companies that aren't among the top 1% have cash-to-debt ratios more similar to those of speculative-grade issuers than to those in the top 1%. Their collective cash-to-debt ratio now stands near 21%.” That's “a slight improvement from 20% reported a year ago but is still very low when compared to the past decade and is only modestly better than the figures reported just before the recession starting in 2008.”

(3) *Bigger is better.* On the other hand, the cash position for the top 1% as a group improved by \$150 billion to nearly \$1.2 trillion in 2017, according to S&P Global. “Their cash-to-debt ratio remains extremely high at 108%, or more than 5x better than that of the remaining investment-grade issuers.” However, that was a significant decrease from 150% reported last year “as the top 1% continued to borrow as a form of synthetic cash repatriation, as well as [the] inclusion of new companies into the top

25 universe.” Cash flow for the top 1% “remains healthy” and “could support significant shareholder returns.”

(4) *Slicing & dicing the S&P 500*. MarketWatch reviewed an interesting analysis from Jefferies in a 5/11 [article](#) titled: “Why a record \$4 trillion in corporate debt isn’t scary.” To understand why, have a look at the chart from Jefferies included in the article. It shows the distribution of net debt to EBITDA ratios among the S&P 500 companies excluding financials. The bottom line is that the bulk of S&P 500 companies have net debt to EBITDA that is well below 6. The “ratio is commonly used by credit-rating firms to see if a company is likely to default on its debt and usually anything above 5 is considered too high, though the ratio varies between industries,” explained the article.

CALENDARS

US. Tues: Factory Orders -0.1%, Motor Vehicle Sales 17.0mu. **Wed:** None. **Thurs:** ADP Employment 188k, Jobless Claims 223k, Challenger Job-Cut Report, ISM & IHS Markit NM-PMIs 58.3/56.5, Weekly Consumer Comfort Index, MBA Mortgage Applications, EIA Petroleum Status Report, FOMC Minutes. **Fri:** Total, Private, and Manufacturing Payroll Employment 190k/183k/15k, Unemployment & Participation Rates 3.8%/62.7%, Average Hourly Earnings 0.2%*m/m*/2.8%*y/y*, Average Workweek 34.5hrs, Baker-Hughes Rig Count, EIA Natural Gas Report. (*Wall Street Journal* estimates)

Global. Tues: Eurozone Retail Sales 0.1%*m/m*/1.6%*y/y*, Canada M-PMI, RBA Cash Rate Target 1.50%. **Wed:** Eurozone, Germany, France, and Italy C-PMIs 54.8/54.2/55.6/53.2, Eurozone, Germany, France, and Italy NM-PMIs 55.0/53.9/56.4/53.3, UK C-PMI & NM-PMI 54.5/54.0, China Caixin NM-PMI 52.7, Japan C-PMI & NM-PMI. **Thurs:** Germany Manufacturing Orders 1.1%*m/m*/1.7%*y/y*, Carney. **Fri:** Germany Industrial Production 0.3%*m/m*/1.5%*y/y*, Canada Net Change in Employment & Unemployment Rate 20k/5.8%, Japan Leading & Coincident Indexes 106.5/116.1. (DailyFX estimates)

STRATEGY INDICATORS

YRI Weekly Leading Index ([link](#)): Our Weekly Leading Index (WLI)—a good coincident indicator that can confirm or raise doubts about stock market swings—remained just below its record high. Our WLI, which is the average of our Boom-Bust Barometer (BBB) and Bloomberg’s Weekly Consumer Comfort Index (WCCI), was flat during the week of June 23, after a two-week jump of 2.1% and a three-week slump of 3.6%; it’s only 1.5% below early May’s record high. Our BBB slipped 0.5% during the latest week after rebounding 2.1% the prior two weeks; it’s within 3.9% of its record high. Jobless claims—one of the components of our BBB—edged up to 222,000 (4-wa) after falling the previous two weeks from 225,500 to 221,000; it’s not far from its recent low of 213,500 six weeks ago—which was the lowest reading since December 13, 1969. Meanwhile, the CRB raw industrial spot price index, another BBB component, continued to reverse recent gains. The WCCI climbed 4.6% over the past three weeks to within 1.4% of its cyclical high.

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings rose for all three of these indexes last week, and was at record highs for all but MidCap. Forward earnings activity has been relatively strong in the past 10 months, as LargeCap’s forward earnings has risen in 47 of the past 48 weeks, MidCap’s is up in 42 of the past 44 weeks, and SmallCap’s is up in 41 of the past 44. Earnings momentum remains healthy, as the yearly change in forward earnings is up from six-year lows in early 2016 and should remain strong in 2018. In the latest week, the rate of change in LargeCap’s forward earnings improved to 21.4% *y/y* from 21.3%, which compares to a seven-year high of 21.7% in mid-May and a six-year low of -1.8% in October 2015; MidCap’s was steady at 22.7%, which compares to a seven-year high of 24.0% in early June and a six-year low of -1.3% in December 2015; and SmallCap’s dropped *w/w* to 32.0% from 32.3%, which was the highest since October 2010 and compares to a six-

year low of 0.3% in December 2015. Here are the latest consensus earnings growth rates for 2018 and 2019: LargeCap 22.1% and 9.8%, MidCap 20.4% and 12.7%, and SmallCap 29.8% and 15.2%.

S&P 500/400/600 Valuation ([link](#)): Last week saw forward P/E ratios move lower for a third straight week. They're all down from 12-week highs in early June to levels that are not much above their recent post-election lows. LargeCap's weekly forward P/E dropped to 16.1 from 16.3, which is up from a post-election low of 16.0 in late March and down from 18.6 on January 26—the highest since May 2002. That compares to the post-Lehman-meltdown P/E of 9.3 in October 2008, but is well below the tech-bubble record high of 25.7 in July 1999. MidCap's forward P/E fell to 16.4 from 16.7, which is up from its 25-month low of 16.1 in early April. MidCap's P/E is down from a 15-year high of 19.2 in February 2017 and compares to the record high of 20.6 in January 2002; however, it is up from a three-year low of 15.0 in January 2016. MidCap's P/E had mostly been at or below LargeCap's P/E from August to March for the first time since 2009. SmallCap's P/E dropped sharply to 17.2 from 17.8, which compares to a post-election low of 17.0 in mid-March. That's well below its 51-week high of 20.2 in December (which wasn't much below the 15-year high of 20.5 in December 2016, when Energy's earnings were depressed), but is comfortably above its three-year low of 15.5 in February 2016. Looking at daily forward price/sales (P/S) ratios, they also improved w/w for all three indexes, but remain at levels well below January highs: LargeCap's P/S of 2.00 is down from a record high of 2.19 on January 26; MidCap's 1.32 compares to its record high of 1.40, also on January 26; and SmallCap's 0.99 is down from 1.05 then, which compares to its record high of 1.17 in November 2013, when Energy revenues were depressed.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): With the books closed on Q2 results, analysts are making last-minute checks and finalizing their earnings models. The S&P 500's Q2-2018 EPS forecast rose 4 cents w/w to \$39.20. That's up 0.6% since the end of Q1, 7.9% ytd, and 8.6% since the passage of the TCJA. The \$39.20 estimate represents a forecasted pro forma earnings gain for Q2-2018 of 20.7%, up from a 20.6% forecast a week earlier and 19.8% at the end of Q1. That compares to Q1-2018's 26.6% (which is the strongest since Q4-2010), Q4-2017's 14.8%, Q3-2017's 8.5%, Q2-2017's 12.3%, and Q1-2017's 15.3%. Since the end of Q1, Q2-2018 estimates are higher for four sectors, down for six, and steady for Real Estate. Energy's Q2 forecast has surged 15.3%, followed by the forecasts for Tech (2.0%), Materials (1.8), and Health Care (0.9). Consumer Staples is the biggest decliner, with its Q2-2018 forecast down 5.0% since the end of Q1, followed by Telecom (-4.3), Consumer Discretionary (-2.7), Industrials (-1.9), Utilities (-0.9), and Financials (-0.8). The S&P 500's Q2-2018 forecasted earnings gain of 20.7% y/y would be its eighth straight gain after four declines. All 11 sectors are expected to record positive y/y earnings growth in Q2-2018—with eight rising at a double- or triple-digit percentage rate—and four are expected to beat the S&P 500's forecasted y/y earnings gain of 20.7%. That compares to all 11 sectors rising y/y during Q1-2018, when ten rose at a double-digit pace and four outpaced the S&P 500. Analysts expect Energy to report another large profit jump in Q2 relative to very low earnings a year ago, with the pace improving from Q1. The latest forecasted Q2-2018 earnings growth rates vs their Q1-2018 growth rates: Energy (140.9% in Q2-2018 vs 88.7% in Q1-2018), Materials (33.3, 39.4), Tech (25.5, 36.5), Financials (22.1, 30.7), S&P 500 (20.7, 26.6), Consumer Discretionary (16.5, 18.7), Industrials (14.9, 24.8), Telecom (7.4, 14.7), Health Care (11.1, 16.2), Consumer Staples (10.0, 13.1), Real Estate (2.3, 3.1), and Utilities (1.3, 16.4). On an ex-Energy basis, analysts expect S&P 500 earnings to rise 17.0% y/y in Q2, down from 24.5% in Q1; that compares to 12.7% in Q4-2017 and 6.1% in Q3-2017 (which was the slowest growth since ex-Energy earnings rose just 2.2% in Q2-2016).

S&P 500 Q2 Earnings Trend vs Past Quarters ([link](#)): With the June-quarter books closed, the current Q2-2018 EPS forecast of \$39.20 is up 0.6% over the 13 weeks since the quarter's start. That's only the second time the forecast has risen since Q2-2011, and the 14th increase in the 97 quarters dating back to 1994. The 0.6% gain in the forecast since the end of the prior quarter compares to an average

decline of 4.1% over the same time period since 1994 and a TCJA-boosted 5.1% rise during Q1-2018. Analysts expect EPS for Q2-2018 to be up 20.3% y/y on a frozen actual basis, which would mark the eighth straight quarter of higher EPS on a y/y basis and the third straight quarter of double-digit percentage growth. While the current forecast is a tad below the 23.2% growth rate recorded for Q1-2018, it has a good chance of beating that mark and achieving the strongest growth since a 34.2% gain during Q4-2010. Since 1994, the Q2 earnings surprise has been positive in 21/24 years (all but 1998, 2002, and 2008). Q2 should mark the S&P 500's record 38th straight quarter of positive surprises—a streak dating back to Q1-2009.

US ECONOMIC INDICATORS

Construction Spending ([link](#)): Construction spending in May reached a new record high as both private and public construction spending continued heading higher. Total spending increased for the eighth time in nine months, by 0.4% in May and 5.8% over the period. Public construction spending has been climbing steadily since last September, up 9.4% over the period—to its best level since October 2010—while private construction spending recorded its sixth increase in seven months, for a total advance of 4.6%. Within private construction, nonresidential investment has been bouncing around record highs, showing little change since jumping 4.9% during the four months through February. Meanwhile, residential investment recovered 1.3% during the two months ending May, after slumping 2.4% in March, not far from February's cyclical high. Single-family construction more than reversed recent losses, rebounding 0.6% in May to a new cyclical high, while multi-family construction remained in a volatile flat trend around record highs. Meanwhile, home-improvement spending climbed 0.9% in May and 1.7% ytd.

GLOBAL ECONOMIC INDICATORS

Global Manufacturing PMIs ([link](#)): Global manufacturing activity in June slowed to an 11-month low, while trade concerns dropped business optimism to a 19-month low. June's JP Morgan M-PMI fell for the fifth month since reaching a near-seven-year high of 54.5 in December, sinking to 53.0 in June. The recent weakness reflects the slowest growth in world production since last July and the weakest new order inflows in 19 months—on a deterioration in new export orders. Developed nations (to 54.4 from 54.7) continued to record much stronger growth than emerging ones (51.2 from 51.1), though both have slowed since late last year, with the former's M-PMI the weakest since last August and the latter's barely budging from May's 10-month low. Among the larger industrial nations, rates of expansion remained above the global average in the US and the Eurozone, despite easing over the month. These M-PMIs show the US (55.4 from 56.4) manufacturing sector outperformed the Eurozone's (55.0 from 55.5) for the second month, with the former easing steadily from April's 3.5-year high of 56.5, while growth in the latter was at an 18-month low—slowing every month since the start of the year. Within the Eurozone, M-PMIs for five of the eight nations covered registered slower rates of growth than in May, including the two best performers—the Netherlands (60.1, 9-month low) and Austria (56.6, 18-month low). Weaker expansions were also seen in Germany (55.9, 18-month low), Greece (53.5, 2-month low), and France (52.5, 16-month low), with the latter dropping to the bottom of the list. Meanwhile, Ireland's M-PMI (56.6, 5-month high) was the only one showing stronger growth, while Spain's (53.4) was unchanged at May's 9-month low. Japan's M-PMI (53.0 from 52.8) improved slightly from recent lows, while the UK's (54.4 from 54.3) was broadly unchanged. China's M-PMI (51.0 from 51.1) showed a slight easing in growth, while M-PMIs in six nations covered by the survey showed activity contracted last month: Brazil (49.8 from 50.7), Denmark (49.7 from 47.8), Malaysia (49.5 from 47.6), Russia (49.5 from 49.8), South Korea (49.8 from 48.9), and Turkey (46.8 from 46.4), though all but Turkey are just shy of the breakeven point.

US Manufacturing PMI ([link](#)): Manufacturing activity in June accelerated at a vigorous pace according

to the ISM measure, while it held just below April's 3.5-year high according to the IHS Markit gauge. The ISM M-PMI climbed for the second month from 57.3 in April to 60.2 last month—just shy of February's 14-year high of 60.8. Both the new orders (to 63.5 from 63.7) and production (62.3 from 61.5) indexes remained above 60.0—the former's for the 13 straight month, while the latter's would have matched that string were it not for a brief dip below 60.0 in April. The new export orders sub-index climbed to 56.3 after falling steadily from 62.8 in February to 55.6 by May. Meanwhile, the supplier deliveries (68.2 from 62.0) gauge soared to its best reading in 14 years, while employment (56.0 from 56.3) growth was little changed from May's pace; inventories (50.8 from 50.2) remained around the breakeven level. IHS Markit's M-PMI (55.4 from 56.4) slipped to a four-month low, but rounded off the best quarter for manufacturing (at 56.1) in almost four years. The concern is what lies ahead: While output growth remained strong in June, it eased to a seven-month low, while the upturn in new orders was the softest since November 2017. Meanwhile, the report noted that “new business from abroad contracted for the first time since July 2017 (albeit only slightly), amid reports of weaker foreign client demand following recent tariff announcements.”

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