MORNING BRIEFING
July 12, 2018

Pills & Chips

See the collection of the individual charts linked below.

(1) Worldwide semiconductor sales at record high. (2) Trade war over "Made in China 2025" spells trouble for chip equipment makers. (3) China could short-circuit M&A. (4) Controlling drug prices with presidential tweets. (5) SmidCap Health Care stocks in feverish rally mode as investors seek trade-immune equities. (6) M&A driving Health Care Equipment prices up. (7) Good prognosis for Health Care services. (8) Managing to cut costs. (9) Amazon is popping pills.

Technology: Bargaining Chips. A world increasingly filled with electronics and sensors has helped keep the market for semiconductors robust. The most recent data point comes from the Semiconductor Industry Association's 7/2 press release, which reports that worldwide semiconductor sales climbed in May by 3.0% m/m and 21.0% y/y to a new record high (*Fig. 1*). The S&P 500 Semiconductors stock price index is up 11.9% ytd (*Fig. 2*).

However, concerns about the duration of the cycle and the impact of the Trump trade war have weighed on the S&P 500 Semiconductor Equipment industry stock price index, which has lost 5.7% ytd through Tuesday's close (*Fig. 3*). Here are some of the ways a trade war could hurt the semi equipment industry:

(1) *Made in China 2025*. Semiconductor equipment companies are in the unenviable position of being important to China's future and therefore being a key negotiating chip for President Trump. China wants to create a competitive domestic semiconductor industry as part of its "Made in China 2025" plan. As a result, Chinese companies have become large buyers of semiconductor equipment.

More than 20% of Applied Materials' revenue comes from China, and at Lam Research the share is 15%, a 6/25 *WSJ* article reports. "Krish Sankar of Cowen & Co. estimates that China accounted for about 14% of trailing 12-month revenue, on average, for the eight semiconductor-tool companies he covers. That means the loss of future sales could be significantly more."

(2) *Kyboshing M&A*. There are a number of ways the Chinese government can make life difficult for US semiconductor equipment companies. First, it can slow down—or deny—regulatory approval for mergers and acquisitions. While the country did approve Marvell Technology Group's acquisition of Cavium, it has yet to give its blessing to Qualcomm's $44 billion acquisition of NXP Semiconductors, announced in October 2016. The Qualcomm deal has received approval from eight other government regulatory bodies around the world.

China could also entangle US companies in its courts. A Chinese court ruled against Micron Technology in a patent infringement case brought against the company by Taiwanese foundry UMC. The decision "forced Micron to halt sales of Crucial and Ballistix-branded DRAM modules and SSDs and cease operations at its test and assembly facility in China's Xi'an high-tech zone," according to a 7/10 article in the EE Times. "Micron maintains that its products do not infringe on the UMC patents.

The company maintains that the patent infringement claims were filed by UMC and its Chinese subsidiary, Fujian Jinhua Integrated Circuit Co., in retaliation for accusations by Micron that UMC misappropriated Micron trade secrets, which resulted in a civil lawsuit filed by Micron in U.S. District Court and criminal indictments against UMC and three of its employees brought by Taiwanese authorities." Awfully messy.

(3) *Growth slowing*. Analysts aren't especially optimistic about results next year. Semiconductor equipment revenues growth is expected to decelerate sharply from 25.6% this year to 4.4% in 2019 (*Fig. 4*). Likewise, the industry's earnings are expected to shift from 49.5% growth in 2018 to 1.1% growth next year (*Fig. 5*). The forward P/E is 10.0, moderately lower than in recent years (*Fig. 6*).

The slowdown in S&P 500 Semiconductors is slightly less dramatic, with revenues expected to grow 15.3% this year and 5.1% in 2019. Earnings growth is forecast to jump 30.7% this year, but only 4.3% in 2019. The forward P/E is 13.1, down only a touch from where it has been in recent years (*Fig. 7*).

Health Care: Getting Trumped. All it took was one day of living in the harsh glare of a presidential tweet and a conversation with President Trump for Pfizer to reverse its July 1 drug price increases. Communicating with 280 characters has never been so powerful.

Despite the tweets and recent news that Amazon has entered the drug market, the S&P 500 Health Care stock price index has remained reasonably healthy. It's up 5.2% ytd, a touch more than the S&P 500's 4.5% return. The sector's return is a more impressive 6.8% if the sickly S&P 500 Pharmaceuticals industry is excluded.

Health Care stocks with smaller capitalizations have outperformed their larger counterparts. The S&P 400 MidCap Health Care index is up 22.2% ytd, and the S&P 600 SmallCap Health Care index is up 35.8% (*Fig. 8*). Investors may be looking for immunity from the global trade wars by hiding in Health Care stocks, which are largely domestic outside of the pharma industry.

We've previously noted that the Health Care sector was due for a catch up. Its share of the S&P 500 earnings, 15.2%, is greater than its capitalization share of the S&P 500, 14.2%, and it has been that way since 2015. In most years over the past three decades, the situation has been just the reverse; the Health Care sector's market-capitalization share has been greater than its earnings contribution to the S&P 500 (*Fig. 9*).

Here's how the price performance of the Health Care sector stacks up to that of the 10 other sectors in the S&P 500 ytd through Tuesday's close: Tech (13.9%), Consumer Discretionary (13.4), Energy (7.3), Health Care (5.2), S&P 500 (4.5), Real Estate (0.3), Utilities (-1.3), Materials (-1.7), Financials (-2.7), Industrials (-2.9), Consumer Staples (-7.9), and Telecom Services (-9.2) (*Fig. 10*).

Several industries are driving the Health Care sector higher, most prominently: Health Care Services (15.1%), Health Care Equipment (15.0), Managed Health Care (11.6), Life Sciences Tools & Services (11.1), and Biotechnology (3.1). Meanwhile, Pharmaceuticals is in the sick bay, down 1.6%, along with Health Care Distributors (-10.0) (*Fig. 11*). Let's take a look at why some Health Care industries are the picture of health, while others need a doctor's visit:

(1) *Healthy equipment*. The Health Care Equipment industry has benefitted from a raft of mergers as companies have sought ways to boost revenues and gain bargaining power in the face of hospital consolidation. Just last month, a 6/13 *WSJ* article reported that Stryker, which makes knee- and hip-replacement parts, approached Boston Scientific, which makes heart devices like pacemakers and stents. Stryker came out shortly thereafter to say that it was not in discussions with Boston Sci, but

never denied approaching the company.

Talk about that potential deal follows Becton Dickinson's acquisition of CR Bard last year and Abbott Laboratories' purchase of St Jude Medical in 2016. Boston Scientific's shares are up 35.4% ytd, and Stryker's are up 12.6%. Another industry high-flier is Edwards Lifesciences, up 30.5% ytd. Its growth comes from the sale of transcatheter heart valves, which replace diseased aortic valves without open-heart surgery. The company also announced an accelerated share repurchase agreement in May to buy about 2.5 million shares.

The Health Care Equipment industry is expected to grow revenues by 10.1% this year and 6.3% in 2019 (*Fig. 12*). That's forecasted to result in 11.6% earnings growth in this year and 10.6% earnings growth in 2019 (*Fig. 13*). Much of the strong earnings growth may already be reflected in the industry's forward P/E multiple of 21.6, which has recovered nicely from roughly 10 in 2009 (*Fig. 14*).

(2) *Healthy services*. The S&P 500 Health Care Services industry was driven higher by LabCorp, up 15.7% ytd, and by Quest Diagnostics, up 14.7%. Both companies provide testing services to the health care industry, and both have been extremely acquisitive in recent years. For example, LabCorp purchased in July 2017 Chiltern, a contract research company, for $1.2 billion. In LabCorp's Q1, the company reported $2.9 billion of revenues, an 18.0% y/y jump, with 13.4% of the growth coming from acquisitions and 3.2% from organic revenues growth. The remaining difference was due to foreign currency translation.

The Health Care Services industry is expected to see revenues climb by 1.2% this year and 3.6% in 2019. Analysts are calling for 22.0% earnings growth this year, slowing to only 5.7% in 2019. The industry's forward P/E ratio of 10.0 may reflect the much slower growth the industry's largest players can expect if they don't find new acquisitions to absorb (*Fig. 15*).

(3) *Managing well*. The S&P 500 Managed Health Care space has been driven higher by the 29.5% ytd return of Centene shares and the 25.9% return of Humana stock. Centene, a Medicaid-focused health insurer, acquired Health Net for $6.3 billion last year and announced a $3.8 billion deal for Fidelis Care earlier this year.

The moves are in line with the industry's consolidation trend, prompted by the need to cut costs and grow through acquisitions. Humana shares have benefitted from reports that Walmart is in preliminary talks to buy the insurer. The reported discussions follow news that CVS is acquiring Aetna and Cigna is getting hitched to Express Scripts.

Centene and others are also set to benefit by expanding their Affordable Care Act (ACA) offerings. Many insurers' ACA business has become profitable after years of rate increases that have helped premiums catch up to costs, a 6/21 *WSJ* article explained.

Analysts are calling for the S&P 500 Managed Health Care industry's 2018 revenues to climb 8.8% and its 2019 revenues to grow by a similar amount, 8.2% (*Fig. 16*). Earnings are expected to grow by 23.9% this year and 12.7% in 2019. The industry's forward P/E, at 16.6, isn't far above its expected earnings growth, but it is high relative to levels of the past two decades (*Fig. 17*).

(4) *A bitter pill*. The S&P 500 Pharmaceuticals industry faces a double whammy, from President Donald Trump and Amazon.com. After Pfizer and other drug companies raised some drug prices on July 1, President Trump tweeted: "Pfizer & others should be ashamed that they have raised drug prices for no reason. We will respond!"

His comments were followed by some equally threatening thoughts from Health and Human Services Secretary Alex Azar. He warned that drug makers who raised prices have created a tipping point in US drug pricing policy, a 7/9 Reuters article reported. He wrote: "Change is coming to drug pricing, whether painful or not for pharmaceutical companies." One day later, Pfizer did an about-face. It will defer drug price increases until year-end or until the President's drug-pricing blueprint goes into effect, whichever is earliest, a 7/10 Reuters article reported.

Were that not enough pressure, Amazon announced its acquisition of PillPack, an online pharmacy startup that can ship prescriptions to customers' homes in 49 states. PillPack's specialty is packaging a month's supply of pills for chronic-disease patients. The acquisition could be a first step toward Amazon offering all sorts of drugs over the Internet, putting pressure on drug prices and challenging brick-and-mortar pharmacies.

Amazon already offers non-prescription medications at lower prices than can be found in brick-and-mortar stores. "Median prices for over-the-counter, private-brand medicine sold by Walgreens Boots Alliance Inc. and CVS Health Corp. were about 20 percent higher than Basic Care, the over-the-counter drug line sold exclusively by Amazon, according to a report Friday by Jefferies Group analysts," a 7/6 Bloomberg article reported. "Amazon began selling the Basic Care line in August with roughly 35 products and has since expanded its range to 65 drugs, according to the Jefferies analysts. The products include mild painkillers, cold and flu medication, sleeping aids and other medication commonly found in the pharmacy aisle." That's certainly something that could make pharma companies sick.

The S&P 500 Pharmaceuticals industry is expected to see revenues increase by 4.8% this year and 2.7% in 2019 (*Fig. 18*). After a healthy 11.6% increase this year, earnings growth is forecast to slow to 4.9% in 2019 (*Fig. 19*). The softer growth rate in 2019 may explain the industry's below-market forward P/E of 13.7 (*Fig. 20*).

CALENDARS

US. Thurs: Headline & Core CPI 2.9%/2.2% y/y, Jobless Claims 225k, Weekly Consumer Comfort Index, Treasury Budget -$91.0b, EIA Natural Gas Report. **Fri:** Import & Export Prices 0.1%/0.3%, Consumer Sentiment Index 98.4, Baker-Hughes Rig Count, Bostic. (*Wall Street Journal* estimates)

Global. Thurs: Eurozone Industrial Production 1.2%m/m/2.3%y/y, Germany CPI 0.1%m/m/2.1%y/y, BOE Credit Conditions & Bank Liabilities Surveys. **Fri:** Japan Industrial Production, China Trade Balance $27.2b. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): Our Bull/Bear Ratio (BBR) climbed for the first time in four weeks this week, to 2.83, after falling from 3.12 to 2.53 the prior three weeks. Nearly all the movement continues to be between the bullish and correction camps. Bullish sentiment jumped 5.3ppts this week to 52.4% after a three-week fall of 8.4ppts (to 47.1% from 55.5%), while the correction count dropped 5.2ppts to 29.1%, following a three-week spike of 7.6ppts (34.3% from 26.7%). Bearish sentiment ticked down from 18.6% to 18.5% this week—and has fluctuated in a narrow band between 17.6% and 18.6% the past five weeks. The AAII Ratio was little changed at 41.5% last week, after falling the prior three weeks from 67.4% to 41.1%. Bullish sentiment dropped from 44.8% to 27.9% the past three weeks, while bearish sentiment slipped to 39.3% last week, after climbing the previous two weeks from 21.7% to 40.8%.

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. The forward revenues growth forecast dropped 0.2ppt w/w to 6.0%, and forward earnings growth slipped 0.8ppt to 13.9%. 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 revenues growth of 6.0% is little changed from an 80-month high of 6.3% at the end of February, and compares to a cyclical low of 2.7% in February 2016. The annual 2018 and 2019 revenues growth forecasts were steady w/w at 7.9% and 5.1%, respectively. Forward earnings growth of 13.9% is at a 25-week low and down from 16.9% in February, which was the highest since October 2010. Still, that's up 2.8ppts from 11.1% prior to the passage of the TCJA, and up 9.1ppts from the cyclical low of 4.8% in February 2016. Turning to the annual earnings growth expectations, the earnings growth forecast for 2018 improved 0.1ppt w/w to 22.3%, and that for 2019 rose 0.1ppt to 10.0%. Energy's contribution to forward growth peaked at the start of 2017. The S&P 500 ex-Financials forward revenues growth forecast dropped 0.3ppt w/w to 6.2%, and the forward earnings growth forecast fell 0.7ppt to 13.1%. The S&P 500 ex-Financials forward profit margin was steady at 11.3%, which compares to a record high of 11.4% in mid-June and 10.4% before the TCJA. Valuations were mixed w/w as the S&P 500's forward P/E dropped to 16.1 from 16.2, 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 edged up 0.01ppt to 1.98, which 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 revenues and earnings forecasts rose w/w for all 11 of the sectors. 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 had a w/w improvement in their forward revenues growth forecast (Financials and Utilities) as eight fell. Real Estate was the only sector to post a w/w improvement in forward earnings growth as 10 sectors fell. Forward P/S and P/E ratios are down from their recent highs in early 2018 for all sectors, and just four improved w/w: Health Care, Real Estate, Telecom, and Utilities. 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 1.27 compares to a record high of 1.56 in May 2016, and its P/E of 17.2 is down to a 42-month low now 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. Five sectors had their forward profit margin rise 0.1-0.2ppt w/w: Energy, Financials, Industrials, Materials, and Tech. 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 (13.6), Utilities (12.5), S&P 500 (12.2), Materials (11.3), Health Care (10.5), Industrials (10.2), Consumer Discretionary (8.0), Consumer Staples (7.6), and Energy (7.4). Energy's forward profit margin is now the highest since December 2014. Among the remaining 10 sectors, all but two (Real Estate and Health Care) are at or near recent record highs.

GLOBAL ECONOMIC INDICATORS

Global Leading Indicators (*link*): In May, 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) and Japan (100.0) CLIs continued to anticipate stable growth momentum. Meanwhile, easing growth momentum remains the assessment for the UK (99.1), the Eurozone (99.9) as a whole—including Germany (100.2), France (99.7), and Italy (100.0)—and now Canada (99.6) as well, which showed signs of easing growth momentum in the prior report. Among major emerging economies, the

CLI for the industrial sector in China (99.6) now points to growth gaining momentum, which remains the assessment for India (101.4). Stable growth momentum is now expected in Russia (100.7), while tentative signs of easing growth momentum are emerging in Brazil (103.7)—downgraded for the second month; Brazil's CLI was showing signs of stabilizing growth momentum in April, after showing signs of gaining momentum in March's report.

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