



MORNING BRIEFING

July 24, 2018

The Big Boost

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

(1) Tax receipts dropping relative to GDP. (2) Supply-siders may take credit for rising individual income tax receipts despite (or because of) tax cuts. (3) Consumers saving less. (4) TCJA giving big boost to profits. (5) Weekly fundamental indicators remain bullish for stocks. (6) Forward earnings at another record high. (7) What's better (or worse): Inverting yield curve or rising bond yield? (8) 2-year Treasury yield closely tracking 12-month forward federal funds futures. (9) Rumored change in BOJ policy putting upward pressure on bond yield, confirming our globalized bond market thesis. (10) A really great review of my book in CFA Institute's *Financial Analysts Journal*.

US Economy: Tax Cuts Working. So far, the escalating trade and currency wars aren't weighing on the weekly stock market fundamentals that Joe and I track and discuss in the next section. That's because the US economy received a big boost from the Tax Cuts and Jobs Act (TCJA) at the end of last year. Federal tax receipts as a percentage of nominal GDP dropped from 18.2% during Q4-2017 to 17.5% during Q1-2018 ([Fig. 1](#) and [Fig. 2](#)). That's the lowest reading since Q4-2012. Normally, this ratio drops during recessions, not during expansions. So the TCJA is giving a big boost to an economy that is already at full employment. Let's have a closer look:

(1) *Consumer incomes.* The y/y growth rate of income taxes in personal income fell to 3.6% during May, down from a recent peak of 7.1% at the end of last year ([Fig. 3](#)). The ratio of personal income taxes to personal income has been in a flat trend around 12.5% since 2015. It edged down to the bottom of the range in May ([Fig. 4](#)). In other words, it's hard to see the tax cut in these data because personal income has been growing, boosting individual income tax receipts even after TCJA-reduced tax rates. I suppose supply-siders can take credit (perhaps prematurely) for this development.

By the way, also contributing to the strength of consumer spending is the downtrend in the personal savings rate, which started in late 2015 ([Fig. 5](#)). Incredibly, the 12-month sum of personal saving has been nearly halved from a recent high of \$829 billion during November 2015 to \$458 billion during May ([Fig. 6](#)).

(2) *Corporate profits.* Corporate profits also received a big boost from the TCJA. In the GDP accounts, corporate profits taxes plunged from \$446 billion (saar) during Q4-2017 to \$332 billion during Q1 of this year ([Fig. 7](#)).

Industry analysts have raised their 2018 consensus estimate for S&P 500 earnings per share by \$13.35 since late last year through the first week of July ([Fig. 8](#)). That's a 9.0% increase that is mostly attributable to the slashing of the corporate tax rate.

Stocks: Weekly Fundamentals. The recent weakness in some key commodity prices, such as the price of copper, hasn't weighed heavily on the CRB raw industrials spot price index ([Fig. 9](#)). Meanwhile, initial unemployment claims remains at its lowest readings since early December 1969 ([Fig. 10](#)). As a result, our Boom-Bust Barometer (BBB), which is the ratio of the CRB index to jobless claims, remained

in record-high territory during the 7/14 week ([Fig. 11](#)). Here's more:

(1) *Forward earnings*. Our BBB is highly correlated with S&P 500 forward earnings, which soared to yet another record high of \$170.21 per share during the July 19 week ([Fig. 12](#)).

(2) *YRI-FSMI*. Our Fundamental Stock Market Indicator (FSMI) is simply the average of our BBB and the weekly Consumer Comfort Index ([Fig. 13](#)). It remains at record highs, and has been highly correlated with the S&P 500 since 2000.

Bonds: Beware of What You Wish For. There has been lots of chatter and agita about the flattening of the yield curve this year. It is widely believed that if the yield curve inverts, then a recession would be imminent. That's what has happened in the past. The Fed is currently projecting a couple of increases in the federal funds rate this year and again next year. So the 10-year Treasury bond yield, currently around 3.00%, would have to rise to avert an inversion relative to the 2-year Treasury note yield. That could also be a troublesome scenario for stock investors, and certainly for bond investors. Consider the following:

(1) *2-year Treasury*. The 2-year Treasury note is mostly driven by expectations for Fed policy. There is a very close correlation between this yield and the 12-month forward federal funds rate in the futures market ([Fig. 14](#)). On Friday, the former was 2.60%, while the latter was 2.52%. The current federal funds target range is 1.75%-2.00%. So the futures market is anticipating two 25bps rate hikes over the next 12 months.

(2) *10-year Treasury*. While the 2-year Treasury note yield has increased by 71bps ytd, the 10-year Treasury yield has been eerily subdued around 3.00% since the start of the year ([Fig. 15](#)).

I've argued that's because global investors are attracted to US government bonds given that comparable yields in Germany and Japan are near zero ([Fig. 16](#)). Yesterday's action in the bond market confirmed this thesis. The US yield rose closer to 3.00% on news that the Bank of Japan is "actively discussing changes to its policies," according to a Reuters [report](#) posted yesterday on CNBC. According to the article: "Sources said the BOJ is holding preliminary discussions on making changes to interest-rate targets and stock-buying techniques, with a focus on ways to make the massive stimulus program more sustainable."

As a result, the yield on the 10-year JGB rose "as much as six basis points" all the way up to 0.09%! Hold on now: That's still awfully close to zero and well below the comparable US yield. The article observed: "The central bank has been gradually reducing its bond buying since September 2016, when it set a policy target of zero percent in the 10-year JGB yield, relegating its quantitative bond buying target to a secondary role."

The total assets of the Bank of Japan, in yen, soared 274% from June 2012 through June of this year ([Fig. 17](#)). The y/y growth rate has been slowing since it peaked at a record 47% during February 2014 ([Fig. 18](#)). It was down to 7% during June. Given that inflation remains close to zero in Japan, the BOJ is likely to keep its short-term official interest rate, which is currently slightly negative, close to zero. The Bank is also likely to maintain its long-term interest-rate policy (under "Yield Curve Control"), which should keep 10-year JGB yields close to zero as well.

The next meeting of the BOJ's Policy Board will take place on July 30-31.

My Book. [Predicting the Markets](#) received a very favorable [review](#) in the latest issue of the *Financial Analysts Journal*, which is published by the CFA Institute. Here is the abstract:

“Investors keen to explore one brilliant economist's analysis of how markets perform, economic leaders think, and investors commit funds in the global economy will find this book to be a reliable, long-term companion. The author's insights and superlative narrative style make this a book to refer to often. Investors will appreciate his views on Federal Reserve Bank policy over the years and his entertaining but serious look at valuation methods. They will also enjoy his retrospective analysis that sets the stage for present and future market trends.”

CALENDARS

US. Tues: C-PMI, M-PMI, and NM-PMI Flash Estimates 56.3/54.9/56.4, Richmond Fed Manufacturing Index, FHFA Price Index 0.4%. **Wed:** New Home Sales 669k, MBA Mortgage Applications, EIA Petroleum Status Report. (*Wall Street Journal* estimates)

Global. Tues: Eurozone, Germany, and France C-PMI Flash Estimates 54.8/54.8/54.9, Eurozone, Germany, and France M-PMI Flash Estimates 54.7/55.5/52.5, Eurozone, Germany, and France NM-PMI Flash Estimates 55.1/54.5/55.7, Japan M-PMI Flash Estimate. **Wed:** Germany Ifo Business Climate, Current Assessment, and Expectation Indexes 101.5/104.9/98.3, Australia CPI 2.2% y/y. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings rose to record highs for all three of these indexes last week. Forward earnings activity has been relatively strong in the past 12 months, as LargeCap's forward earnings has risen in 50 of the past 51 weeks, MidCap's is up in 45 of the past 47 weeks, and SmallCap's is up in 44 of the past 47. 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 rose to a seven-year high of 21.9% y/y from 21.6%, which compares to a six-year low of -1.8% in October 2015; MidCap's rose to 23.6% from 23.4%, 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 edged down w/w to 31.5% from 31.6%, which compares to 32.0% in late June (the highest since October 2010) and a six-year low of 0.3% in December 2015. Here are the latest consensus earnings growth rates for 2018 and 2019: LargeCap 22.2% and 10.0%, MidCap 20.5% and 12.9%, and SmallCap 29.4% and 15.3%.

S&P 500/400/600 Valuation ([link](#)): Forward P/E ratios were mostly steady last week, but remain 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 of 16.5 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 of 16.6 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 edged up to 17.8 from 17.7, 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 2.04 is down from a record high of 2.19 on January 26; MidCap's 1.34 compares to its record high of 1.40, also on January 26; and SmallCap's 1.03 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 Q2 results beginning to be released at a faster pace, analysts are digesting the news and starting to adjust future expectations. The S&P 500's Q3-2018 EPS forecast edged down two cents w/w to \$40.95. That's down 0.3% since the end of Q2, but up 8.5% ytd and 9.2% since the passage of the TCJA. The \$40.95 estimate represents a forecasted pro forma earnings gain for Q3-2018 of 23.1%, down from 23.2% a week earlier and up from 22.1% at the end of Q1. That compares to Q2-2018's blended 22.0%, 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 Q2, Q3-2018 estimates are higher for three sectors, down for six, and steady for two. The Q3 forecast has risen for Financials (up 0.6%), Industrials (0.5), and Tech (0.2). Consumer Staples, Energy, and Materials are the biggest decliners, with their Q3-2018 forecast down 0.5% since the end of Q2, followed by 0.1% declines for Consumer Discretionary and Health Care. The S&P 500's Q3-2018 forecasted earnings gain of 23.1% y/y would be its ninth straight gain after four declines. All 11 sectors are expected to record positive y/y earnings growth in Q3-2018, but eight are expected to rise at a double- or triple-digit percentage rate compared to eight during Q2. However, just three are expected to beat the S&P 500's forecasted y/y earnings gain of 23.1% compared to four during Q2. 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 Q3 relative to very low earnings a year ago, with the pace slowing from Q2. The latest forecasted Q3-2018 earnings growth rates vs their blended Q2-2018 growth rates: Energy (103.7% in Q3-2018 vs 144.9% in Q2-2018), Financials (45.1, 24.9), Materials (33.4, 32.6), S&P 500 (23.1, 22.0), Telecom (19.4, 9.9), Industrials (19.2, 17.1), Consumer Discretionary (19.1, 15.7), Tech (16.9, 26.4), Health Care (10.8, 11.9), Consumer Staples (9.6, 11.1), Utilities (6.3, 2.6), and Real Estate (4.6, 2.8). On an ex-Energy basis, analysts expect S&P 500 earnings to rise 20.0% y/y in Q3, up from a blended 18.2% in Q2; that compares to 24.5% in Q1-2018, 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 Season Monitor ([link](#)): With over 18% of S&P 500 companies finished reporting earnings and revenues for Q2-2018, the percentage of companies with positive surprise results is higher compared to the same point during the Q1 earnings season, but companies' overall percent surprise for Q2 and their y/y growth rate metrics are a tad lower. Of the 91 companies in the S&P 500 that have reported through mid-day Monday, 84% exceeded industry analysts' earnings estimates by an average of 5.0%; they have averaged a y/y earnings gain of 24.4%. At the same point during the Q1-2018 reporting period, a lower percentage of companies (77%) in the S&P 500 had beaten consensus earnings estimates by a higher 6.0%, and earnings were up a higher 27.3% y/y. On the revenue side, 74% of companies beat their Q2 sales estimates so far, with results coming in 1.4% above forecast and 10.5% higher than a year earlier. At this point in the Q1 season, a lower 69% had exceeded revenue forecasts by a higher 1.6%, and sales had risen by a similar 10.5% y/y. Q2 earnings results are higher y/y for 95% of companies, vs a lower 91% at the same point in Q1, and Q2 revenues are higher y/y for 92% vs 91% a quarter ago. The early results on revenues are very encouraging, particularly the percentage of companies growing revenues y/y. Q2-2018 should mark the eighth straight quarter of positive y/y earnings growth and among the highest growth since Q4-2010. The strong results are mostly due to lower tax rates and improved business conditions, with a small benefit due to currency translation.

US ECONOMIC INDICATORS

Existing Home Sales ([link](#)): Existing home sales retreated for the third month in June, despite strong homebuyer demand. Existing home sales—tabulated when a purchase contract closes—fell -0.6% in June, and -3.9% the past three months, to 5.38mu (saar). It fell on an annual basis for the fourth

straight month, down -2.2% y/y. According to NAR's chief economist, the root cause is without a doubt the severe housing shortage, noting, "What is for sale in most areas is going under contract very fast and in many cases, has multiple offers. This dynamic is keeping home price growth elevated, pricing out would-be buyers and ultimately slowing sales." Regionally, sales were below year-ago levels in the West (-5.0% y/y), Northeast (-4.0), and Midwest (-3.1), with sales in the South (0.4) flat. Single-family sales contracted -4.6% during the three months ending June to 4.76mu (saar), while multi-family sales were flat at 620,000 units in June, after rising two of the prior three months by 6.9%. The number of existing single-family homes on the market at the end of June climbed for the sixth month from 1.29mu to 1.74mu over the period, and was 1.2% above a year ago—after recording y/y declines for 36 straight months. However, NAHB's chief economist underscores that despite the modest year-over-year rise in inventory, the current level is far from what's needed to satisfy demand levels, especially since the strong economy is bringing more interested buyers into the market, and new home construction is failing to keep up. Unsold single-family inventory was at a 4.4 months' supply, rising steadily from December's record low of 3.1 months. The median existing single-family home price was \$279,300 in June, 5.2% above a year ago, with all regions experiencing y/y gains, led by a double-digit increase in the West (10.0% y/y), while price gains in the Northeast (3.5), Midwest (3.5), and South (3.0) were in low single digits.

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