MORNING BRIEFING
July 25, 2018

Ahead & Behind Schedule

See the collection of the individual charts linked below.

(1) Same old story. (2) S&P 500 forward revenues still soaring. (3) S&P 500 forward earnings jumps to $170 per share, six months ahead of schedule. (4) An 18 P/E now would put S&P 500 at 3100! (5) Happy hook in Q2 earnings. (6) Four S&P 500 sectors with forward revenues ascending in record-high territory. (7) Smaller is beautiful thanks to less exposure to trade war and better revenues and earnings growth. (8) Contrary to urban legend, real wages have been on a uptrend since mid-1990s. (9) Baby Boomers who refuse to retire may be keeping a lid on overall wage measure.

Strategy I: Awesome Earnings. Don't blame us for repeating the same old story: S&P 500 earnings are awesome. Of course, that's been the increasingly obvious story since President Donald Trump signed the Tax Cuts and Jobs Act (TCJA) at the end of last year. However, Joe and I observed during the summer of 2016 that earnings were recovering from the global growth recession of 2015, which was caused by the full-blown recession in the world's energy industry. Let's update the same old story:

(1) *Revenues still soaring.* Notwithstanding all the chatter about slowing global economic growth and Trump's escalating trade war between the US and the rest of the world, industry analysts continue to raise both their 2018 and 2019 revenues estimates for the S&P 500 (*Fig. 1*). Revenues are now expected to increase 7.9% this year and 5.1% next year. Forward revenues remains on the steep uptrend that started in early 2016, as the global economy started to recover from the growth recession of 2015. It has been in record-high territory since October 2016. The slope has been as steep as during the 2010-2011 recovery from the Great Recession. It's really quite extraordinary, and certainly has nothing to do with Trump's ascent into the White House.

(2) *Earnings still getting boosted after TCJA.* Also extraordinary is that the forward earnings of the S&P 500 rose to $170.21 per share during the 7/19 week (*Fig. 2*). That has been our target all year for the end of this year, not the middle of this year. So we are well ahead of schedule.

Remarkably, industry analysts are still raising their consensus estimate for next year, which has edged up to $177.34. That's very important, because forward earnings is converging to next year's consensus estimate. So the ascent in forward earnings will continue as long as the 2019 estimate either continues to rise or flattens out.

Meanwhile, the Q2-2018 earnings season is underway. It's still early, but the blended actual/estimated metric has been rising so far this month (*Fig. 3*). That shouldn't be surprising since more often than not, there is an upward-sloping hook in this number during earnings seasons because analysts' earnings estimates tend to be too low coming into earnings seasons. What is surprising is that this is happening now after the HUGE hook for all four quarters of this year that appeared following enactment of the TCJA. As of the 7/19 week, here are the actual, blended, and estimated y/y growth rates for 2018's four quarters: Q1 (23.2%), Q2 (21.1), Q3 (22.4), and Q4 (18.7).

(3) *Profit margin at record high.* Joe and I divide forward earnings by forward revenues to calculate the forward profit margin. For the S&P 500, it was 11.1% just before the TCJA was passed. Now it is up to a record high 12.3% as of the 7/19 week.

S&P 500 forward revenues, forward earnings, and the forward profit margin are all very good real-time indicators of the actual quarterly numbers for these three important metrics (*Fig. 4*)

(4) *P/E weighed down by better earnings.* The meltup in earnings estimates following the passage of TCJA triggered a meltup in the stock market during January (*Fig. 5*). All was going according to our schedule for the market meltup until the sharp selloff in early February, when the S&P 500 dropped 10.2% from its record high on January 26 to 2581 on February 8. The index's forward P/E dropped from 18.6 on January 23 to a recent low of 15.9 on May 3 (*Fig. 6*).

If the P/E would recover back to 18 today, the S&P 500 would be at 3100 today. That remains our year-end target. We were aiming for forward earnings (E) to be at $170 per share by then with an earnings valuation multiple (P/E) of 18. Currently, we are ahead of schedule on the E, but behind schedule on the P/E. If the E continues to move higher, we won't need as high a P/E to get to 3100. Of course, all this comes with an updated hedge clause: "barring an escalating trade and currency war."

(5) *Bullish sector revenues.* Drilling down into the forward revenues of the 11 S&P 500 sectors, we find that four are ascending in record-high territory: Consumer Discretionary, Health Care, Industrials, and Information Technology (*Fig. 7*). Still rebounding from their 2015 recession levels are Energy and Materials.

Here is the sector derby for consensus expected revenues growth in 2018 and 2019: Energy (18.7%, 3.4%), Information Technology (12.1, 7.4), Materials (10.4, 2.5), Real Estate (9.9, 4.9), S&P 500 (7.9, 5.1), Consumer Discretionary (7.8, 5.9), Industrials (7.5, 5.1), Telecom Services (6.9, 4.5), Health Care (5.9, 5.3), Consumer Staples (4.4, 3.7), Financials (3.7, 5.2), and Utilities (1.3, 2.4). (For industry-level detail, see our *Earnings & Revenue Growth 2019E/2018E/2017A*.)

Strategy II: Smaller Is Even Better. Interestingly, the forward revenues and forward earnings of the S&P 600 SmallCaps have been outpacing the comparable metrics for the S&P 500/400 since the start of the year:

(1) *Forward revenues*. Here are the ytd performances of forward revenues for the S&P 500/400/600: 5.5%, 5.8%, and 13.1% (*Fig. 8*).

(2) *Forward earnings.* Here are the ytd performances of the forward earnings of the three: 15.8%, 17.1%, and 27.1% (*Fig. 9*).

(3) *Stock price indexes.* Here are the ytd performances of the S&P 500/600/400 stock price indexes: 5.0%, 5.1%, and 12.8% (*Fig. 10*).

(4) *Bottom line.* The widely held view is that SmallCaps have outperformed because they are less exposed to the escalating trade and currency war. That does make sense. However, their underlying fundamentals are also improving faster on a relative basis. They may be getting a bigger after-tax earnings boost from the TCJA than larger corporations that have had the means to dodge taxes better than smaller ones.

That still begs the question of why their revenues are so strong on a relative basis. Perhaps Trump's deregulation policies are also benefitting smaller companies more than larger ones. After all, regulations are often promoted by large companies to keep small competitors at bay. The monthly survey conducted by the National Federation of Independent Business shows that significantly fewer small business owners have been complaining about government regulation and taxes since Trump was elected (*Fig. 11*).

Wages: Facts & Fiction. The suspense continues: Will wage inflation finally rebound as the labor market continues to tighten? Before we go there, Debbie and I need to vent a little bit. There has been lots of ranting by progressively inclined economists and politicians claiming that inflation-adjusted wages have been flat for the past 20 years. That's just not true.

Inflation-adjusted average hourly earnings for all workers is up 10% since the start of the data during March 2006 (*Fig. 12*). We are using the personal consumption deflator to adjust for inflation.

Data for the average hourly earnings of production and nonsupervisory workers are available since 1964 (*Fig. 13*). Such workers typically have accounted for about 80% of all workers. Divided by the PCED, this measure of real wages rose during the 1960s. It mostly declined during the 1970s through the mid-1990s. It is UP 29% over the past 23 years, from May 1995 through May of this year. That certainty can't be described as "wage stagnation."

Meanwhile, the labor market continues to tighten, yet nominal wage inflation remains remarkably subdued, with both of the measures cited above up only 2.7% y/y during June. A few economists believe that there may be more slack in the labor market than suggested by the low unemployment rate. They expect that more people, especially prime-age males who dropped out of the labor force, may start dropping back in.

There are many other theories proffered by economists to explain why wage inflation remains subdued, particularly as measured by average hourly earnings. We give more weight to a demographic explanation. Consider the following:

(1) *Wages by age cohorts.* The Atlanta Fed compiles its Wage Growth Tracker by age (*Fig. 14*). The data show that wage inflation rose sharply for 16- to 24-year-olds from 3.5% during February 2013 to a recent peak of 8.4% during November 2016. It was down, but still high, at 7.1% during April.

Over roughly the same period since early 2014, wage inflation rose for 25- to 54-year-olds from roughly 2.0% to 3.5%, with April's result at 3.4%. Again, over the same period, wage inflation for workers 55 and older rose from about 1.0% to 2.0%, which was also April's reading.

(2) *More older workers.* Here's the thing: Many Baby Boomers are working well beyond the traditional retirement age of 65. Many older workers are already well paid, and simply receive small or no pay increases. The percentage of employment attributable to the 55+ crowd has increased from 13.0% at the start of 2000 to 23.3% currently (*Fig. 15*). The percentage that is attributable to those aged 16-24 has decreased from 15.1% to 12.3% over the same period.

CALENDARS

US. Wed: New Home Sales 669k, MBA Mortgage Applications, EIA Petroleum Status Report. **Thurs:** Durable Goods Orders Total, Ex Transportation, and Core Capital Goods 3.2%/0.5%/0.5% m/m, Advance Goods Trade Balance -$67.2b, Kansas City Fed Manufacturing Index, Jobless Claims 219k, Weekly Consumer Comfort Index, EIA Natural Gas Report. (*Wall Street Journal* estimates)

Global. Wed: Germany Ifo Business Climate, Current Assessment, and Expectation Indexes

101.5/104.9/98.3, Australia CPI 2.2% y/y. **Thurs:** Germany Gfk Consumer Confidence 10.7, Japan Headline, Core, and Core-Core CPI 0.7%/0.7%/0.4% y/y, ECB Rate Decision 0.00%, ECB Marginal Lending Facility & Deposit Facility Rate 0.25%/-0.40%, Draghi Press Conference. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 TCJA Earnings Leaders & Laggards (*link*): The 2018 earnings forecast for the S&P 500 has surged 10.1% in the 31 weeks since the TCJA was signed into law on December 22. This outstanding performance has no comparison over the years since consensus earnings forecasts were first derived in 1978. The rate of change in the consensus forecasts has slowed since the Q1 earnings season as analysts appear to have fully incorporated lower tax rates into their estimates. The top sector gainers since the TCJA was passed: Energy (43.1%), Telecom (16.7), Financials (12.3), Materials (12.1), and Industrials (10.2). Real Estate is the sole decliner, with a drop of 0.3%; also underperforming the S&P 500 are Consumer Staples (1.3), Utilities (1.9), Health Care (6.6), Consumer Discretionary (6.8), and Tech (8.6). Higher oil prices have contributed heavily to the improvement in Energy's 2018 earnings forecast.

S&P 500 Sectors Net Earnings Revisions (*link*): The S&P 500's NERI was positive for a 15th straight month in July, its longest positive streak since the 26-month string ending August 2011. With revisions now reflecting the impact of "animal spirits" rather than the passage of the TCJA, NERI remained very strong despite falling to a seven-month low of 7.7% from 8.7% and from a record high of 22.1% in March. NERI improved m/m for 5/11 sectors and was positive for nine sectors (compared to four improving and eight positive in June). Tech has the longest positive NERI streak, of 24 months, the best since August 2011 when its 28-month streak ended. Financials has the next best positive streak at 22 months, followed by Materials (10), Energy (9), and Industrials (8). Real Estate's NERI turned positive in July for the first time in 11 months. Consumer Staples and Telecom have the worst track record recently, with three months of negative NERI. Most sectors remain near their recent TCJA-boosted highs; Consumer Staples has fallen to a 39-month low. Here are the sectors' July NERIs compared with their June readings, ranked in descending order: Energy (17.4% in July, up from 14.2% in June), Tech (14.1, 16.1), Materials (10.0, 13.2), Industrials (9.8, 9.7), Financials (9.4, 7.5), Health Care (8.4, 9.8), Consumer Discretionary (5.0, 7.6), Utilities (3.7, 4.0 [47-month high]), Real Estate (1.9 [11-month high], -1.2), Telecom (-4.3, -7.0), and Consumer Staples (-16.7 [39-month low], -9.0).

S&P 500 Earnings, Revenues & Valuation (*link*): S&P 500 consensus per-share forecasts for forward revenues edged down last week for a second week from a record high, but forward earnings rose to another record. The forward revenues growth forecast was steady w/w at 6.0%, and forward earnings growth was unchanged at 13.9%. The forward profit margin edged up 0.1ppt to a record high of 12.3%, 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 six-month 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 edged up 0.1ppt w/w to 22.4% for 2018 and remained steady at 10.0% for 2019. Energy's contribution to forward growth peaked at the start of 2017. The S&P 500 ex-Financials forward revenues growth forecast was steady at 6.2%, and the forward earnings growth forecast remained at 13.1%. The S&P 500 ex-Financials forward profit margin rose 0.1ppt w/w and now matches the record high of 11.4% in mid-June and well exceeds the 10.4% before the TCJA. Valuations were higher w/w as the S&P 500's forward P/E rose to a 13-week high of 16.7 from 16.5, 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 improved 0.03ppt to an 18-week high of 2.05, which compares to late January's record high of 2.16 and early May's low of 1.95.

S&P 500 Q2 Earnings Season Monitor (*link*): With over 22% 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 about the same. Of the 111 companies in the S&P 500 that have reported through mid-day Tuesday, 84% exceeded industry analysts' earnings estimates by an average of 6.1%; they have averaged a y/y earnings gain of 27.5%. 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 slightly lower 6.0%, and earnings were up a nearly similar 27.3% y/y. On the revenue side, 74% of companies beat their Q2 sales estimates so far, with results coming in 1.5% above forecast and 10.7% higher than a year earlier. At this point in the Q1 season, a lower 69% had exceeded revenue forecasts by a slightly higher 1.6%, and sales had risen by a slightly lower 10.5% y/y. Q2 earnings results are higher y/y for 94% of companies, vs a lower 91% at the same point in Q1, and Q2 revenues are higher y/y for 91% 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

Regional M-PMIs (*link*): The three Fed districts that have reported on manufacturing activity for July so far—New York, Philadelphia, and Richmond—all showed continued robust growth. We average the composite, orders, and employment measures as data become available. The composite index (to 22.8 from 22.0) wasn't far from its recent high of 24.3 recorded in October—which was the best reading since May 2004. The Philadelphia (to 25.7 from 19.9) region accelerated back toward May's (34.4) vigorous pace—which was the fastest in a year, while New York's (22.6 from 25.0) slowed slightly from June's eight-month high; Richmond's (20 from 21) virtually matched June's pace. The new orders gauge (23.9 from 20.4) rebounded back toward May's 14-year high, as an acceleration in orders growth in the Philadelphia (31.4 from 17.9) region more than offset a deceleration in New York's (18.2 from 21.3); Richmond's (22) measure matched June's pace. The employment gauge (18.7 from 24.1) eased after recording its best showing in the history of the series going back to 2001 in June. Richmond (22 from 23) factories hired at roughly the same healthy pace as they did in June, while manufacturers in both the Philly (16.8 from 30.4) and New York (17.2 from 19.0) regions showed slower, but still robust, jobs growth—though Philly's was about half June's rate.

GLOBAL ECONOMIC INDICATORS

US PMI Flash Estimates (*link*): US private-sector growth remained strong in July for both manufacturing and service-providing industries, while inflationary pressures escalated. This month's C-PMI (to 55.9 from 56.2) eased slightly for the second month after reaching a 37-month high of 56.6 in May. The M-PMI (55.5 from 55.4) was little changed from June's four-month low, though was also not that far from April's 43-month high of 56.5. According to the report, manufacturers saw solid growth in domestic demand, which helped to offset another slight fall in export sales. However, although only marginal, the latest drop in new work from abroad was the greatest seen since May 2016. The NM-PMI (to 56.2 from 56.5) edged down for the second month since reaching a three-year high of 56.8 in May. There were signs of reduced pressure on operating capacity this month, despite another sharp rise in new business intakes. This was underscored by a fall in backlogs of work for the first time since April 2017. Overall, the report warned, "Trade frictions have clearly become a major cause of concern, especially among manufacturers. Firms have become increasingly worried about the impact of tariff and trade wars on demand, prices and supply chains. July saw the steepest rise in prices charged for goods and services yet recorded by the surveys as firms passed rising costs on to customers, in turn frequently linked to tariffs. What's more, supply chain delays also hit a record high amid rising shortages of key inputs, which is usually a harbinger of further price rises."

Eurozone PMI Flash Estimates (*link*): The Eurozone lost momentum again at the start of Q3, after a brief rebound in June, according to flash estimates. July's C-PMI slipped from 54.9 to 54.3 this month, back near May's 18-month low of 54.1; it was at a 139-month high of 58.8 at the start of this year. The report notes that while the rate of growth was relatively robust this month, weakened new order inflows and reduced business expectations of future activity added to the downbeat picture. The NM-PMI (to 54.4 from 55.2) pulled back from June's four-month high, posting the second-slowest expansion seen in the past 18 months, while the M-PMI flash estimate ticked up to 55.1, after falling steadily from a six-month high of 60.6 in December to a 19-month low of 54.9 in June. The report notes that new export orders registered the smallest monthly rise since August 2016, slowing "sharply since the buoyant pace recorded earlier in the year." By country, Germany's C-PMI (to 55.2 from 54.8) climbed from a 20-month low to a five-month high this month, boosted by an acceleration in its M-PMI (57.3 from 55.9); the NM-PMI (54.4 from 54.5) held around June's four-month high. France's C-PMI (54.5 from 55.0) flash estimate revealed a slight slowing in growth; the M-PMI (53.1 from 52.5) showed a slight acceleration, the NM-PMI (55.3 from 55.9) a slight deceleration. Meanwhile, across the rest of the Eurozone, growth was the weakest in 21 months, slipping lower in both manufacturing and services. "The big question going forward will be the extent to which domestic demand can remain sufficiently resilient to cushion the eurozone economy from the potential adverse impact of an escalating trade war on exports. For now, the health of domestic demand seems encouragingly solid, but any feed-through of trade worries to other sectors will be a key area of concern to an already cloudier-looking outlook," according to the survey.

Japan M-PMI Flash Estimate (*link*): Japan's manufacturing sector expanded at its slowest pace since November 2016, according to the flash estimate, and business confidence dipped noticeably. The M-PMI fell for the fourth time in six months this month, to a 20-month low of 51.6, since peaking at 54.8 at the start of this year. Both output and new orders increased at a slower pace this month, as new export orders contracted for the second month; hirings also slowed. Meanwhile, the report notes, "Slowing demand presents a worrying development given input delivery times lengthened to the sharpest extent in over seven years. Supply chain difficulties reportedly contributed to the fastest rate of input price inflation in since March 2011. Although output prices were raised at a relatively notable pace, the rate of increase was far weaker than that of costs, implying profit margin erosion."

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