



MORNING BRIEFING

August 8, 2018

Tuning Out the Noise

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

(1) Two remarkable back-to-back quarters for earnings. (2) Two more to go. (3) Getting closer to our year-end S&P 500 target of 3100. (4) Three happy earnings hooks. (5) Forward earnings converging to higher 2019 estimates. (6) Lots of earnings power in S&P 500 sectors. (7) Jamie Dimon is bearish on bonds. (8) Bears warn that corporate pensions' tax-related bond-buying will end in September. (9) Inflationary pressures are mounting, but broad inflation measures remain subdued. (10) US bond yield tethered to German and Japanese yields. (11) Noise about escalating trade war weighing on global manufacturing.

Stocks: Strong Earnings Signal. The Q2 earnings season, which is nearly over, has been almost as remarkable as the Q1 earnings season, when industry analysts scrambled again to raise their 2018 and 2019 earnings estimates to reflect the passage of the Tax Cuts and Jobs Act (TCJA) at the end of last year. Such Q2 strength on the heels of such Q1 strength suggests that earnings have been boosted by more than just the slashing of the corporate tax rate under the TCJA.

US economic growth has also been strong during the first half of this year. That too might be attributable to the stimulative impact of the TCJA, as well as to the ongoing lift to earnings from the Trump administration's business deregulation. So far, neither the rise in short-term interest rates nor the increase in the trade-weighted dollar nor the escalating trade war has weighed on earnings. Joe and I think that earnings will remain strong over the rest of this year. Our year-end target of 3100 for the S&P 500 is only 8.5% above yesterday's close. Consider the following:

(1) *Happy earnings hooks.* Q1 earnings for the S&P 500 turned out to be 5.3% better than expected by industry analysts at the start of that earnings season ([Fig. 1](#)). So far, the earnings surprise for Q2 is 3.7%. Similar ascending hooks are visible for S&P 400/600 Q2 earnings following Q1's happy hooks. Q2's y/y growth rates were as awesome as Q1's were: S&P 500 (24.8% following 23.2%), S&P 400 (22.2, 26.8), and S&P 600 (36.5, 34.8) ([Fig. 2](#)).

(2) *Forward earnings at fresh record highs.* While 2018 and 2019 earnings estimates may be starting to level out at their latest record highs for the rest of the year, forward earnings continue to rise to new record highs for the S&P 500/400/600 as they converge toward the elevated 2019 estimates by the end of this year ([Fig. 3](#)).

For the S&P 500, forward earnings rose to \$171.93 per share during the 8/2 week. At the beginning of the year, when it was \$147.23, we thought we were optimistic carrying a year-end target of \$170.00. Forward earnings by definition will equal the 2019 consensus estimate at the end of this year. Currently, the 2019 consensus is at \$178.64! That number is more likely to come down than go up from here. But for now, it is pulling forward earnings higher.

(3) *Many happy sector returns.* The forward earnings of the S&P 500 is up 16.9% since the passage of TCJA through the 7/26 week ([Fig. 4](#)). Here is the comparable performance derby for the S&P 500

sectors: Energy (58.8), Telecom (21.2), Financials (18.9), Industrials (18.8), Materials (17.4), S&P 500 (16.9), Tech (15.4), Consumer Discretionary (14.1), Health Care (12.6), Utilities (5.0), Consumer Staples (5.0), and Real Estate (2.7). All are at or near recent new record highs except Energy and Financials.

So far this year through July, the Net Earnings Revision Index readings have been solidly positive for Consumer Discretionary, Energy, Financials, Health Care, Industrials, Information Technology, Materials, and Utilities ([Fig. 5](#)).

Bonds: Noise-Canceling Headphones. On Saturday at the Aspen Institute's 25th Annual Summer Celebration Gala, JP Morgan Chase Chief Jamie Dimon warned that the 10-year US Treasury bond yield could go much higher: "I think rates should be 4% today. You better be prepared to deal with rates 5% or higher—it's a higher probability than most people think."

He should know. Then again, the yield isn't "4% today." Rather, it has been eerily stable around 3.00% since the beginning of the year, even though the Fed raised the federal funds rate twice so far this year, and is expected to do so two more times by the end of this year ([Fig. 6](#) and [Fig. 7](#)). The 12-month forward fed funds rate futures was at 2.61% Monday. The 2-year US Treasury note yield has closely tracked that futures yield, and is up 75bps ytd to 2.64% through Monday.

I've spilled some ink of late about the tug of war in the bond market between the bears and the bulls. Here is some more on the subject:

(1) *The bears.* Dimon is clearly bearish, and the Bond Vigilantes Model confirms his view that the bond yield should be closer to the growth rate of nominal GDP, which was 5.4% y/y during Q2.

The bears rightly observe that the TCJA and additional fiscal spending approved by Congress at the beginning of the year will significantly boost the federal deficit in coming years. Since last October, the Fed has been on course to slash its holdings of Treasuries and MBSs through 2024. And Fed officials have strongly signaled more rate hikes next year, aiming to raise the federal funds rate to 3.00%.

The bears observe that demand for US Treasuries has been temporarily bolstered this year by impending tax reform, which has spurred US companies to shift billions into corporate pension plans, increasing demand for longer-dated maturities. By doing so, the companies qualify for tax deductions before the new lower rate of 21% takes effect in mid-September.

Meanwhile, some countries, most notably Russia, may be responding to Trump's sanctions and tariffs by reducing their holdings of US Treasuries.

In addition, there is mounting anecdotal evidence that inflationary pressures are building. Some are doing so in the labor market, which is very tight. Some are related to Trump's tariffs. The national M-PMI's prices-paid index dipped in July to 73.2 from a recent high of 79.5 during May ([Fig. 8](#)). That index was mostly well below 50.0 during 2015 and early 2016. The national NM-PMI prices-paid index remained relatively high at 64.5 last month. (Prices-received indexes are not available for the national surveys of purchasing managers.)

Debbie and I calculate similar averages for the five Fed districts that survey business conditions each month. The regional prices-paid index rose to 48.3 during July, the highest reading since May 2011 ([Fig. 9](#)). It was just below zero in early 2016. The regional prices-received index rose to 26.2 last month, the highest since August 2008.

(2) *The bulls.* So why isn't the US bond yield soaring? The bulls respond that trying to forecast the bond market using flow-of-funds supply-vs-demand analysis has never worked. It's fairly obvious that US bond yields are tethered to comparable German and Japanese yields, which are near zero, and are likely to remain there given the stated policies of both the ECB and BOJ to keep their official rates near zero for the foreseeable future.

Inflationary pressures may appear anecdotally to be building, but July's average hourly earnings measure of wages remained subdued at 2.7% y/y. June's headline PCED was up 2.2% y/y and 1.9% on a core basis ([Fig. 10](#)). Inflationary expectations as reflected in the yield spread between the 10-year bond and its comparable TIPS remains subdued around 2.1% ([Fig. 11](#)). Companies' record profit margins are likely to absorb some of the cost pressures before they show up in prices.

All that may be so, but what about the record amount of debt worldwide that continues to accumulate? One person's debt is someone else's asset. Debt may be at a record high, but so is wealth, which is also growing. Some of that wealth will always be invested on a risk-off basis. Some investors are worrying that all that debt will eventually lead to yet another financial calamity. Ironically, many are buying government bonds because they are deemed to be safe assets!

Then again, September is coming. The kids will be going back to school. The question is: Will the bond yield rise back above 3.00% on the way to Dimon's 4%-then-5% target? I don't think so. I'm playing on both sides of the tug of war in the bond market until I see a clear winner.

Global Economy: Tinnitus. While US stock and bond investors are doing a great job of tuning out the noise coming out of Washington, the global economy may be starting to get disorienting tinnitus, i.e., a ringing in the ears, from all the noise about an escalating trade war.

This is most evident in the global M-PMI, which has dropped from a recent high of 54.5 at the end of last year to 52.7 during July ([Fig. 12](#)). The global NM-PMI is holding up better around 54.0, as it has been since early 2017 ([Fig. 13](#)). That's not surprising since manufacturing industries are much more vulnerable to an escalating trade war than services industries.

CALENDARS

US. Wed: MBA Mortgage Applications, EIA Petroleum Status Report, Barkin. **Thurs:** Jobless Claims 220k, PPI-FD 0.3%/0.3%/0.2%, Wholesale Inventories 0.0%, EIA Natural Gas Report, Evans. (*Wall Street Journal* estimates)

Global. Wed: Japan Machine Orders -0.8% m.m./10.0% y/y, China Trade Balance \$39.05b, China Exports & Imports 10.0%/17.0% y/y. **Thurs:** Japan GDP (annualized) 1.4% q/q, China CPI & PPI 2.0%/4.5% y/y, Canada Housing Starts 219.5k, Mexico CPI 4.81% y/y, ECB Publishes Economic Bulletin. (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—is just shy of a new record high. Our WLI, which is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI), climbed 1.6% during the four weeks ending July 28, just 0.7% below early May's record high. Our BBB rebounded 2.5% over the four-week period, and was within 2.6% of its record high. Jobless claims—one of the components of our BBB—moved down for the fourth week to 214,500 (4-wa), nearly matching its recent low of 213,500 11 weeks ago, which was the lowest reading since

December 13, 1969. Meanwhile, the CRB raw industrial spot price index, another BBB component, has been sliding again. The WCCI dipped slightly after a seven-week jump of 7.7% to a new cyclical high.

S&P 500 Q2 Earnings Season Monitor ([link](#)): With Q2 results in hand for over 85% of the S&P 500 companies, we find a higher percentage of companies reporting positive surprises than at the same point during the Q1 earnings season but a lower overall percentage surprise. Year-over-year growth rate metrics for the Q2 reporters to date are close to Q1's historically high levels. More specifically, of the 426 companies in the S&P 500 that have reported through mid-day Tuesday, 80% exceeded industry analysts' earnings estimates by an average of 5.2%; they have averaged a y/y earnings gain of 26.0%. At the same point during the Q1-2018 reporting period, a similar percentage of companies (80%) in the S&P 500 had beaten consensus earnings estimates by a higher 7.2%, and earnings were up a lower 24.7% y/y. On the revenue side, 72% of companies beat their Q2 sales estimates so far, with results coming in 1.6% above forecast and 10.3% higher than a year earlier. At this point in the Q1 season, a higher 76% of reporting companies had exceeded revenue forecasts by a lower 1.1%, and sales had risen by a lower 8.3% y/y. Q2 earnings results are higher y/y for 84% of companies, vs a higher 86% at the same point in Q1, and Q2 revenues are higher y/y for 87% vs 87% also a quarter ago. These results are very encouraging, particularly the percentage of companies growing revenues y/y and their Q2 surprise. 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.

US ECONOMIC INDICATORS

JOLTS ([link](#)): Job openings in June were basically flat, after falling in May from April's record high. Openings ticked up 3,000 to 6.662 million in June to within 178,000 of April's record high of 6.840 million. Job openings are up 995,000 ytd, averaging monthly gains of 166,000 the first half of the year. Meanwhile, June hirings declined 96,000 to 5.651 million, after rebounding 261,000 during the two months ending May to a new record high of 5.747 million. Total separations rose for the third time in four months, by a total of 329,000, to a new record high of 5.502 million. The latest hiring and separations data yielded an employment advance of 149,000 for June, considerably below June's payroll increase of 248,000—coming in below the payroll gain for second time in three months, after exceeding it the previous seven months. June's job-opening rate remained at 4.6% after reaching a new record high of 4.7% in April, while both the quit (2.5%) and total hire (4.2) rates ticked down from their cyclical highs in May. June's ratio of unemployed workers per job opening remained below 1.00, though edged up to 0.98 after falling the prior three months to a new record low of 0.91 in May.

Consumer Credit ([link](#)): Consumer credit expanded in June at less than half May's pace, on a slight decline in revolving credit. Overall credit rose \$10.2 billion in June, to another new record high, after a \$24.3 billion jump in May—which was the strongest showing this year. Revolving credit contracted a small -\$0.2 billion after rising at a six-month high of \$9.6 billion in May. Meanwhile, nonrevolving credit, which includes student and auto loans, rose \$10.4 billion, below May's \$14.7 billion, but matching the average gain posted the first four months of this year.

GLOBAL ECONOMIC INDICATORS

Germany Industrial Production ([link](#)): German industrial production fell more than expected in June, remaining stalled around record highs. Germany's headline production—which includes construction—fell -0.9% (vs -0.5% consensus estimate), following a downwardly revised 2.4% (from 2.6%) jump in May and an unrevised -1.3% decline in April. Excluding construction, output fell -0.6% in June after a 2.4% gain and a -1.8% loss the previous two months. The sector breakdown shows construction (-3.2%) and manufacturing (-0.9) output contracted in June, while energy (2.9) posted its fourth gain in

the past five months. The main industrial groupings showed widespread weakness, with production of consumer nondurable (-1.9), intermediate (-0.8), capital (-0.6), and consumer durable (-0.5) goods production all in the red. Still, while June's report was disappointing, industrial production remained 2.5% above a year ago, nearly 3.0% excluding construction. Looking ahead, Germany's M-PMI in July (to 56.9 from 55.9) improved from June's 18-month low—though remains considerably below December's 63.3. In a separate report, the Federal Statistics Office reported German exports were unchanged in June at their record high, while imports rose 1.2% to a new record high; Germany's trade surplus was back down at April's €19.3 billion—which was the lowest in just over a year.

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