MORNING BRIEFING
September 11, 2018

Red, Blue, and Green Waves

See the pdf and the collection of the individual charts linked below.

(1) Bull-market haters as apoplectic as ever. (2) Lots of reasons to hate this bull market, yet it continues to make new record highs. (3) Is emerging market crisis about to kill the US bull? (4) What if Trump's red wave is drowned by Democrats' blue wave? (5) Lots of red ink in federal budget under both blue and red presidents. (6) Despite drop in its commodity price component, our Fundamental Stock Market Indicator remains near recent record high. (7) The green wave: Jobless claims still falling, as consumer confidence continues to soar. (8) Tech's earnings share at record high, boosting its market-cap share. (9) Financials signaling calm in US, but trouble in Europe.

Strategy I: Giving Bull-Market Haters Their Due. The S&P 500 rose to a record new high of 2914.04 on Tuesday, August 28 (*Fig. 1*). Lately, I've been following some of the social media websites that focus on the stock market. The comments that appear after most stories about the market tend to be dominated by bull-market haters.

They have been foaming at the mouth since the start of the bull market in 2009 right through the recent high for the record books. They are convinced that the bull's recent feats signify a bubble—fueled by too much central bank liquidity, too much corporate debt, too many corporate share buybacks, lots of fake earnings, and dangerously inflated valuation. Trump's stimulative policies are making the top by pumping up stock prices with tax cuts that have temporarily pumped up earnings. But supply-side voodoo won't pay for the tax cuts. The resulting mounting government deficits will lead to higher interest rates, which will balloon government interest payments and inevitably kill the bull. Or so their thinking goes.

More imminently, they see a threat to the stock market unfolding in the emerging markets crisis that could trigger a global bear market—right now! The Fed is on course to continue raising interest rates because the US economy is on course to grow at a solid pace thanks to Trump's stimulative policies. But higher US interest rates are starting to wreak havoc in emerging market economies.

Furthermore, Trump's red wave may be about to be overwhelmed by the Democrats' blue wave during the mid-term congressional elections on November 6. If so, then Trump is finished. The Democrats will bury him with special prosecutors and even impeachment proceedings. The resulting political chaos and uncertainty could also kill the bull.

Before I take up a defense of the bull, I will concede that the bull-market haters are right about most of the bad stuff that obsesses them. The problem is that the bad stuff has been out there for quite some time, and it has mostly gotten worse. Yet lo and behold: The bull market rose to a new record high in late August. I don't have a problem with that. Those who do have missed out on either the best (or second-best) bull market ever, so far.

The red political wave since Trump's election on November 8, 2016 has seen lots of red ink in the government's financial accounts. But that was true over the previous eight years when the blue wave dominated our political establishment. Under the Obama administration, publicly held federal debt more than doubled from $6.3 trillion during January 2009 to $14.4 trillion during December 2016 (*Fig. 2*). It is set to almost double under Trump if he gets a second term, as the federal deficit continues to mount again (*Fig. 3*).

Most unsettling is that US federal government interest payments are already soaring along with the debt as the Fed notches up interest rates. The Fed started normalizing the federal funds rate at the end of 2015. The two-year US Treasury note yield is up from 0.88% to 2.71% since then (*Fig. 4*). The federal government's net interest paid has jumped from $225.5 billion during 2015 to $313.7 billion over the 12 months through July of this year (*Fig. 5*). I'm not as unsettled by the record $5.4 trillion in corporate bonds outstanding, which is up $2.3 trillion since the start of the bull market in March 2009 (*Fig. 6*). The funds those bonds raised for companies were issued at historically low interest rates and locked in for many years.

I've frequently explained in the past why share buybacks aren't a concern for me. Joe and I regularly write about the impressive performance of corporate earnings, which aren't fake, in our opinion. Valuations aren't cheap, but it's recessions that usually kill bull markets, not lofty valuations.

Strategy II: US Stocks Hanging 10 on the Green Wave. I am troubled by the proliferating emerging markets crisis. It is weighing on my favorite global economic indicator: The CRB raw industrial spot price index is down 8% since this year's high on June 12 (*Fig. 7*). It is one of the three components of my Fundamental Stock Market Indicator (FSMI), which has been closely tracking the S&P 500 since 2000 (*Fig. 8*). The FSMI is a coincident indicator of the market. I designed it to determine whether the underlying fundamentals justify the underlying trend in stock prices in the US. Consider the following:

(1) *Boom-Bust Barometer remains near record high.* The FSMI includes our Boom-Bust Barometer (BBB), which is the CRB raw industrials spot price index divided by initial unemployment claims (*Fig. 9*). The BBB is also highly correlated with the S&P 500. The BBB remains elevated despite the recent weakness in the commodity index because jobless claims have fallen to their lowest level in 49 years (*Fig. 10*). The global economy may be weighed down by an emerging markets crisis, but the US labor market is booming.

(2) *US consumers are elated.* While the BBB has stalled at a record high in recent weeks, the third component of the FSMI is soaring. In mid-August, the Weekly Consumer Comfort Index jumped to the highest reading since the end of 2000 (*Fig. 11*). It is up 38% since Trump was elected and 20% since the tax cuts at the end of last year.

(3) *Earnings remain fundamentally bullish.* Of course, there is nothing more fundamentally important to the stock market than earnings. It turns out that both our FSMI and BBB are very highly correlated with S&P 500 forward earnings (*Fig. 12* and *Fig. 13*). This time-weighted average of analysts' consensus expectations for earnings during the current and the coming year has been flying into record-high altitudes since the tax cuts at the end of last year. It was $173.76 per share during the 9/6 week, up 18.0% since the end of last year.

Conclusion: The economy's green wave matters much more to the stock market than the political red and blue waves!

Strategy III: On the Verge of a US Tech Wreck? Yes, but what about valuation? What about it? We all know that stocks aren't cheap. They did get cheaper as a result of the 10.2% correction in the S&P 500 from January 26 through February 8. Did the bull-market haters turn bullish given that opportunity?

Of course not.

I'm getting older and starting to repeat myself, but this is worth repeating: High valuation doesn't kill bull markets; recessions do that. It just so happens that often prior to recessions valuation multiples tend to be elevated when investors forget that recessions naturally occur from time to time. This time, everyone has been on recession watch, especially as the yield curve has flattened.

Furthermore, there are more jitters about high valuations this time than there were during previous bull runs, when valuations were high but bubble concerns explained away as justified by the fundamentals. That's especially true for the S&P 500 Information Technology sector. Granted, there are a few large-cap tech stocks with nosebleed valuations today. However, the forward P/E of the sector was 18.4 during August (*Fig. 14*). During the great tech bubble, multiples were more than twice as high. Furthermore, back then the earnings share of the sector peaked at a then-record high of 18.2% during September 1999 (*Fig. 15*). Last month, it rose to a record high of 23.4%, justifying the current market-cap share, in my opinion.

So what about the recent weakness in the S&P 500 Semiconductors industry? If there is trouble ahead for it and the economy, as some vocal bears proclaim, that isn't apparent yet in the industry's forward revenues and forward earnings (*Fig. 16* and *Fig. 17*). Both rose to new record highs at the end of August. The Net Earnings Revisions Index (NERI) remained solidly positive last month for the 27th month in a row (*Fig. 18*). Our Blue Angels analysis shows that the industry's stock price index has been rising along with forward earnings since early 2013, with the forward P/E remaining around 15 most of the time since then.

On the other hand, Joe warns that the S&P 500 Semiconductor Equipment stock price index is down 22.9% since the industry's January 25 high of the current bull market. The industry's forward revenues and earnings are also looking toppy lately, and NERI has been negative for two months in a row. This may be one industry that is already getting pinched by Trump's escalating trade war. (See our *S&P 500 Industry Briefing: Semiconductor Equipment*.)

Strategy IV: Trusty Financials Are Calm in US, Jittery in Europe. One of the stock market's more reliable coal-mine canaries has been the ratio of the S&P 500 Financials stock price index to the S&P 500. It tends to give an early warning sign of both recessions and bear markets (*Fig. 19* and *Fig. 20*). So far, no news is good news in the US. The S&P 500 Financials stock price index is up 1.0% ytd. So far, the emerging market crisis isn't emerging as a problem for the US financial system.

On the other hand, fears of an Italian debt crisis, along with the emerging market crisis, have weighed on the Europe Financials MSCI, which is down 14.9% ytd and 22.9% from its January 25 peak (in local currencies) (*Fig. 21*). While the NERI for the S&P 500 Financials sector remained positive for the 23rd month in a row during August, it was negative for the fifth month in a row in Europe (*Fig. 22*).

CALENDARS

US. Tues: NFIB Small Business Optimism Index 108.2, Job Openings 6.665m. **Wed:** PPI-FD Total, Core, and Core Ex Trade Services 0.2%/0.2%/0.2%, Atlanta Fed Business Inflation Expectations, MBA Mortgage Applications, EIA Petroleum Status Report, Beige Book. (Econoday estimates)

Global. Tues: Germany ZEW Survey Current Situation & Expectations 72/-13.5, UK Employment Change & Unemployment Rate (3-month) 9k/4.0%, Mexico Industrial Production 1.0% y/y. **Wed:** Eurozone Industrial Production -0.5%m/m/1.0%y/y, Japan Machine Orders 5.7%m/m/4.5%y/y. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose to record highs for all three of the market-cap indexes last week, and SmallCap's was at a record for the first time in five weeks. Forward earnings activity has been relatively strong in the past 12 months: LargeCap's and MidCap's forward earnings have risen in 50 of the past 52 weeks, and SmallCap's in 45. 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 was steady at a seven-year high of 22.7% y/y, which compares to a six-year low of -1.8% in October 2015; MidCap's rose to a seven-year high of 24.0% from 23.8%, which compares to a six-year low of -1.3% in December 2015; and SmallCap's edged up w/w to 34.1% from 34.0%, which compares to an eight-year high of 34.8% in mid-August and a six-year low of 0.3% in December 2015. Here are the latest consensus earnings growth rates for 2018 and 2019: LargeCap 22.9% and 10.3%, MidCap 21.6% and 12.5%, and SmallCap 28.3% and 15.7%.

S&P 500/400/600 Valuation (*link*): Forward P/E ratios fell last week and remain at levels not much above their post-election lows in March. LargeCap's weekly forward P/E dropped to 16.5 from a 24-week high of 16.7, which compares to a post-election low of 16.0 in late March and is down from 18.6 on January 26—the highest since May 2002. That also 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 16.5 from a 10-week high of 16.7, which compares to a 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 has been at or below LargeCap's P/E for most of the time since August 2017—the first time that alignment has prevailed since 2009. SmallCap's P/E slipped to 18.0 last week from a 24-week high of 18.3, 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 the three indexes' daily forward price/sales (P/S) ratios, most were higher w/w but remain at levels well below January highs: LargeCap's P/S fell w/w to 2.08 from 2.10, and is down from a record high of 2.19 on January 26; MidCap's dropped to 1.33 from 1.34, which compares to its record high of 1.40, also on January 26; and SmallCap's slipped to 1.05 from 1.07, 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 three weeks left in the Q3 book, analysts will soon turn their attention toward adjusting future expectations. The S&P 500's Q3-2018 EPS forecast edged down one cent w/w to $40.64. That's down 1.0% since the end of Q2, but up 7.7% ytd and 8.4% since the passage of the TCJA. The $40.64 estimate represents a forecasted pro forma earnings gain for Q3-2018 of 22.2%, down from 22.4% a week earlier and up slightly from 22.1% at the end of Q1. That compares to Q2-2018's blended 24.8%, Q1-2018's 26.6% (which is the strongest since Q4-2010 and likely to mark the peak of the current earnings cycle), 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 just one sector, down for nine, and steady for one. The Q3 forecast has risen for Financials (up 0.2%), and is unchanged for Materials. Real Estate is the biggest decliner, with its Q3-2018 forecast down 1.6% since the end of Q2, followed by Consumer Discretionary (-1.4), Telecom (-0.5), Utilities (-0.4), Consumer Staples (-0.4), Energy (-0.3), Tech (-0.3), Industrials (-0.2), and Health Care (-0.1). The S&P 500's Q3-2018 forecasted earnings gain of 22.2% 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, with eight at a double-digit percentage rate. That compares to all 11 positive during Q2, when nine rose at a triple- or double-percentage rate. Four sectors are expected to beat the S&P 500's forecasted y/y earnings gain of

22.2% during Q3, matching Q2's measure. 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 (97.8% in Q3-2018 vs 122.0% in Q2-2018), Financials (45.6, 27.2), Materials (31.9, 40.0), S&P 500 (22.2, 24.8), Telecom (22.7, 16.4), Industrials (17.5, 20.4), Tech (16.7, 26.8), Consumer Discretionary (15.5, 23.2), Health Care (10.9, 18.1), Consumer Staples (7.2, 13.8), Utilities (5.3, 8.7), and Real Estate (4.4, 3.3). On an ex-Energy basis, analysts expect S&P 500 earnings to rise 19.3% y/y in Q3, down from a blended 21.9% 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).

US ECONOMIC INDICATORS

Consumer Credit (*link*): Consumer credit in July expanded at roughly double the pace of June, to yet another record high. Overall credit rose $16.6 billion, following downward revisions to both June (to $8.5 billion from $10.2 billion) and May ($21.8 billion from $24.3 billion) data. Nonrevolving credit—which includes student and auto loans—accelerated by $15.4 billion, the biggest monthly advance so far this year, following June's $9.6 billion advance. Revolving credit showed little change the past two months, edging up $1.3 billion in July after edging down -$1.2 billion in June; it had increased at a six-month high of $8.4 billion in May. So far this year, consumer credit has expanded $87.0 billion, with nonrevolving up $79.0 billion and revolving $8.0 billion higher.

GLOBAL ECONOMIC INDICATORS

Global Leading Indicators (*link*): In July, the OECD's composite leading indicators (CLIs)—designed to anticipate turning points in economic activity relative to trend six to nine months ahead—point to easing growth momentum in the OECD (99.7) as a whole. In the major economies, easing growth momentum is anticipated in Germany (100.0), France (99.5), Italy (100.1), and the Eurozone as a whole (99.7), as well as in the UK (99.9). Looking at major non-European CLIs, those for the US (99.8) and Japan (99.7) continue to anticipate stable growth momentum, while similar signs are now emerging for Canada (99.6). Among major emerging economies, the CLI for the industrial sector in China (99.9), as well as India (101.6), point to growth gaining momentum, while growth is expected to ease in Brazil (103.1) and Russia (100.2).

UK Industrial Production (*link*): Industrial output rose in July for the second month, though was below expectations. Headline production ticked up 0.1% after expanding by an unrevised 0.4% in June; these gains followed a three-month slide of -1.3%. Meanwhile, manufacturing production unexpectedly declined -0.2% in July, after rebounding 1.0% during the two months ending June from a three-month slide of -1.7%. Looking at the main industrial groupings, consumer durable goods production continued to soar to new cyclical highs in July, climbing for the eighth time in nine months by a total of 9.7%, while consumer nondurable goods output dipped -1.5% after climbing 3.4% during the three months ending June. Intermediate goods production expanded for the second time in three months, by 1.1%, after falling -3.4% the first four months of the year; it's down -2.3% ytd. Production of capital goods is bouncing around recent lows, down -2.1% since reaching a new record high in March. Looking forward, the UK's M-PMI sank to a 21-month low of 52.8 in August as output and new orders growth eased following the first contraction in new export orders since April 2016, leading to near stagnation in job creation. Meanwhile, business optimism dipped to a 22-month low.

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