



MORNING BRIEFING

September 25, 2018

See You in 2020!

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

(1) Smoking hot pot stocks. (2) Second-hand smoke making industry analysts high? (3) No Wile E. Coyote scenario in S&P 500 revenue estimates. (4) Above-trend earnings growth in 2019 and 2020? (5) High on life. (6) Will S&P 500 profits make new record highs over the next two years? Unlikely. (7) Go Global investment strategy outperformed last week. We are sticking with Stay Home for now. (8) Stay Home has been the big winner during the current bull market.

Strategy I: Something To Look Forward To! Now that pot stocks are smoking, could it be that the second-hand smoke is getting S&P 500 industry analysts high too? Joe and I just added weekly analysts' consensus expectations for 2020 S&P 500 revenues and earnings to our various chart publications, which are updated automatically. We always do so during September for the year following the coming year. So until this week, we've focused only on weekly consensus expectations for 2018 and 2019. We continue to do so, but 2020 is now on our radar screen as well.

In our opinion, the stock market is forward looking and tends to discount analysts' consensus expectations for revenues and earnings over the next 52 weeks. So in addition to tracking annual expectations, which are available (and change) weekly, we also calculate forward revenues and earnings, which are the time-weighted averages of the weekly data for the current year and the coming year.

At the end of this year, forward revenues and earnings will be identical to the respective consensus expectations for 2019. Then as 2019 progresses, 2020 expectations will get increasingly more weight. So without further ado, let's see why the 2020 estimates suggest that industry analysts are smoking something that is making them very high:

(1) *Revenues*. Former Fed Chairman Ben Bernanke famously warned in June that Trump's tax cuts at the end of last year and Congress's big fiscal spending boost at the beginning of this year were big mistakes. "It's going to hit the economy in a big way this year and next," Bernanke said. "And then in 2020, Wile E. Coyote is going to go off the cliff and look down." According to the 6/7 Bloomberg [article](#) on this subject:

"The Congressional Budget Office forecast in April that the stimulus would lift growth to 3.3 percent this year and 2.4 percent in 2019, compared with 2.6 percent in 2017. GDP growth slows to 1.8 percent in 2020 in the CBO projections. Fed officials predicted 2 percent growth in 2020 in their March median projection. The degree of slowdown as stimulus fades is a matter of debate among economists, with some predicting the effects could last beyond two years if the U.S. boosts its capital stock and upgrades its workforce during this period of strong growth. Congress could also write new spending laws to smooth out the program, Bernanke noted."

Industry analysts didn't get Bernanke's fiscal-cliff memo. They are currently forecasting that S&P 500

revenues will increase 4.1% in 2020 following gains of 5.2% in 2019 and 8.4% this year ([Fig. 1](#)). Joe and I are predicting 8.5% this year, 4.0% next year, and 3.0% in 2020. We've observed that this year's revenues performance has been unusually strong given that the economic expansion is no youngster. We attributed it to the ongoing rebound from the 2015 global growth recession. In addition, there has been a lot of fiscal stimulus this year, as Bernanke observed. Also, we are open to the possibility that business deregulation and the corporate tax cut are boosting economic growth, just as supply-siders had predicted.

(2) *Earnings*. Now let's inhale industry analysts' heady expectations for S&P 500 earnings for 2019 and 2020. They are currently forecasting \$178.86 per share for next year, a 10.3% increase following this year's 22.9% tax-rate-cut-supercharged boost. The predicted slowdown isn't surprising since earnings growth should return to its trend. But trend growth has been around 5%-7%, not 10%. Oh, and in 2020, industry analysts are estimating \$194.92 per share, a 9.0% increase and a fourth straight year of above-trend growth.

Are industry analysts all supply-siders now? That's extremely unlikely. More likely is that they are displaying their long-established tendency to be overly optimistic about the prospects for their companies' results well ahead of the release of those results.

Joe and I are high on life, but we aren't as high as the industry analysts. We are predicting \$173 per share next year, i.e., a 6.8% increase. Then for 2020, we are predicting \$185 per share, a 6.9% increase. (See [YRI S&P 500 Earnings Forecast](#).)

(3) *Profit margin*. The S&P 500 profit margin using Thomson Reuter's operating earnings rose to a record high of 10.8% during Q4-2017. The cut in the corporate tax rate at the end of 2017 boosted the margin to a record high of 11.5% during Q2-2018. The analysts' latest revenues and earnings projections imply that the profit margin will rise from 10.8% during 2017 to 11.9% this year. Then they see it going to 12.5% in 2019 and 13.2% in 2020!

Apparently, industry analysts didn't get the memo about rising labor costs that could squeeze profit margins if competitive forces make it hard to raise prices. Then again, if the supply-siders are right, then productivity growth should make a comeback. In this scenario, inflation-adjusted wages can rise, fueled by productivity gains, without putting upward pressure on prices. That would be very bullish. It is a scenario that we think might be an alternative to Bernanke's Wile E. Coyote outlook. Beep, Beep!

Strategy II: Safe To Go Global Already? It's amazing how simple this business can be. When the US economy is outperforming the rest of the world, the dollar tends to be strong. Commodity prices tend to be weak. US stock prices tend to outperform foreign stocks, particularly those of emerging market economies. When the rest of the world is doing well relative to the US, the dollar tends to be weak, commodity prices tend to be strong, and emerging market stock prices tend to do very well.

Last week, the financial markets flipped from the former to the latter narrative. Why is a bit of a mystery. One possibility is that investors and traders around the world decided that perhaps Trump's trade war was more of a skirmish than a war. JP Morgan CEO Jamie Dimon made that very point on September 20. Trump slapped a 10% tariff on \$200 billion of US imports from China. That's a \$20 billion dollar hit that is a drop in the bucket, no matter whether the bucket is in China or the US.

Trump's trade war and Fed Chairman Jay Powell's gradual normalization of US monetary policy seem to have triggered an emerging market (EM) crisis this year with significant drops in the stock prices and currencies of numerous EMs ([Fig. 2](#) and [Fig. 3](#)).

In recent meetings with some of our accounts, I heard some money managers opine that the current emerging market crisis didn't seem as widespread and troublesome as previous episodes. In addition, they observed that forward P/Es in EM markets are downright cheap if the worst is over for those economies; in other words, there isn't much more downside from here. Here is the forward P/E derby for the major MSCI stock price indexes through September 13: Emerging Markets (10.8), EMU (12.8), Japan (12.4), United Kingdom (12.3), and the United States (16.9) ([Fig. 4](#)). The EM valuation multiple has dropped from a 2018 high of 13.1 during January to 10.8 in mid-September. It's true that this is well below the valuation multiple in US markets, but that's the way it has been, more often than not, for a very long time ([Fig. 5](#)).

Notwithstanding the US stock market's underperformance last week, Joe and I are inclined to stick with our Stay Home investment strategy rather than switch to the Go Global alternative ([Fig. 6](#)). That just means we continue to recommend overweighting the US. It doesn't mean that there aren't some attractive opportunities in overseas stock markets. For example, we are keen on Mexico and India for reasons deftly covered in recent months by Sandra Ward, our contributing editor ([Fig. 7](#) and [Fig. 8](#)). However, last week's EM rebound was led by China's MSCI stock price index ([Fig. 9](#)). China, of course, remains at the epicenter of Trump's trade war, while Mexico has dodged his bullets.

By the way, since the start of the current bull market, here is the performance derby of the major MSCI stock market indexes in dollars: United States (332.3%), Japan (116.8), Emerging Markets (116.7), EMU (110.1), and the United Kingdom (97.1) ([Fig. 10](#)). Here it is in local currencies: the United States (332.3%), Japan (146.7), Emerging Markets (132.7), EMU (125.9), and the United Kingdom (107.1) ([Fig. 11](#)).

CALENDARS

US. Tues: Consumer Confidence 131.7, Richmond Fed Manufacturing Index 20, S&P CoreLogic Case-Shiller HPI 0.5% m/m/6.3% y/y, FHFA Home Price Index 0.3%, FOMC Meeting Begins. **Wed:** New Home Sales 630,000 units, MBA Mortgage Applications, EIA Petroleum Status Report, Fed Announcement 2.125% (2.000% to 2.250%), FOMC Forecasts, Powell Press Conference. (Econoday estimates)

Global. Tues: Kuroda. **Wed:** None. (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. 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 rose to 23.2% y/y from 22.9%, which is the highest since January 2011 and compares to a six-year low of -1.8% in October 2015; MidCap's fell to 23.8% from 24.1%, which had been the highest since April 2011 and compares to a six-year low of -1.3% in December 2015; and SmallCap's improved w/w to 34.6% from 33.9%, 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, 2019, and 2020: LargeCap (22.9%, 10.3%, 9.0%), MidCap (21.5, 12.4, 11.1), and SmallCap (29.1, 15.4, 11.1).

S&P 500/400/600 Valuation ([link](#)): Forward P/E ratios were higher last week for LargeCaps, but mixed to lower for the SMidCaps. LargeCap's weekly forward P/E was at a six-month high, as it improved to

16.8 from 16.7 a week earlier, 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 was steady at 16.6, down from a 10-week high of 16.7 at the end of August, 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 fell to a six-week low of 17.7 last week from 18.0 and is down from a 24-week high of 18.3 at the end of August. That compares to a post-election low of 17.0 in mid-March and is 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 rose w/w to 2.11 from 2.09, and is down from a record high of 2.19 on January 26; MidCap's was steady at 1.33, which compares to its record high of 1.40, also on January 26; and SmallCap's fell to 1.04 from 1.06, 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 one week left in the Q3 book, analysts usually turn their attention toward trimming forecasts. The S&P 500's Q3-2018 EPS forecast dropped three cents w/w to \$40.59. That's down 1.1% since the end of Q2, but up 7.5% ytd and 8.2% since the passage of the TCJA. The \$40.59 estimate represents a forecasted pro forma earnings gain for Q3-2018 of 21.7%, unchanged from a week earlier and down from 22.1% at the end of Q1. That compares to Q2-2018's blended 25.0%, 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, the Q3-2018 estimate has risen 0.2% for the Financials sector, was steady for Tech, and has fallen for the remaining nine sectors. Real Estate is the biggest decliner, with its Q3-2018 forecast down 1.6% since the end of Q2, followed by Consumer Discretionary (-1.5), Energy (-1.5), Materials (-1.2), Utilities (-0.6), Telecom (-0.5), Consumer Staples (-0.5), Industrials (-0.3), and Health Care (-0.1). The S&P 500's Q3-2018 forecasted earnings gain of 21.7% 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 21.7% 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 (96.9% in Q3-2018 vs 123.1% in Q2-2018), Financials (41.5, 27.5), Materials (30.7, 40.0), S&P 500 (21.7, 25.0), Telecom (22.8, 16.4), Tech (17.4, 26.8), Industrials (17.0, 20.2), Consumer Discretionary (15.4, 23.1), Health Care (10.8, 18.2), Consumer Staples (7.3, 14.0), Utilities (5.0, 8.7), and Real Estate (4.4, 3.3). On an ex-Energy basis, analysts expect S&P 500 earnings to rise 18.8% 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).

S&P 500 Q3 Earnings vs Past Quarters Trend ([link](#)): Earnings estimate revisions activity for Q3-2018 is returning to the usual pattern of falling just before the earnings reporting season. This follows the unusual pre-reporting estimate increases seen for Q1- and Q2-2018 due to the TCJA. With less than a week before the September-quarter books close, the current Q3-2018 EPS forecast of \$40.59 is down 1.1% over the 12 weeks since the quarter's start. That drop compares to an average decline of 4.0% over the same time period in the 97 quarters dating back to 1994, and the TCJA-boosted gains of 5.1%

and 0.6% during Q1 and Q2, respectively. Analysts expect EPS for Q3-2018 to be up 21.3% y/y on a frozen actual basis, which would mark the ninth straight quarter of higher EPS on a y/y basis and the fourth straight quarter of double-digit percentage growth. While the current forecast is below the 26.0% growth rate recorded for Q2-2018, it has a good chance of beating that mark and achieving the strongest growth since a 34.2% gain during Q4-2010. Since 1994, the Q3 earnings surprise has been positive in 18/24 years (all but 1997-1998, 2001, 2005, and 2007-2008). Q3 should mark the S&P 500's record 39th straight quarter of positive surprises—a streak dating back to Q1-2009.

US ECONOMIC INDICATORS

Regional M-PMIs ([link](#)): Three Fed districts that have now reported on manufacturing activity for September—Philadelphia, New York, and Dallas—and showed growth remained around August's robust pace, with the regions mixed. We average the composite, orders, and employment measures as data become available. The composite index rose to 23.3 this month from 22.8 last month; it peaked at 28.4 last October—which was the best reading since the end of 2004. The Philadelphia region's composite index (to 22.9 from 11.9) shows growth was roughly double the pace of last month, though held below May's 12-month high of 34.4. Meanwhile, Dallas' (28.1 from 30.9) gauge remained near August's strong pace, while New York's (19.0 from 25.6) eased, though remained at an elevated level. The new orders gauge (17.5 from 17.0) virtually matched August's pace, though is below May's heady pace of 28.1. Billings in the Philly (21.4 from 9.9) region accelerated sharply this month, while Dallas' (14.7 from 23.9) decelerated to a six-month low; orders in the New York (16.5 from 17.1) region virtually matched August's pace. The employment measure (16.2 from 18.8) shows job gains were slightly slower than in August, as manufacturers in the Philly (17.6 from 14.3) region hired at a faster rate, while Dallas' (17.7 from 28.9) added to payrolls at a considerably slower pace than last month; New York's (13.3 from 13.1) hired at virtually their August pace.

GLOBAL ECONOMIC INDICATORS

Germany Ifo Business Climate Index ([link](#)): Business confidence in Europe's largest economy fell only slightly this month despite worries about trade disputes that could harm growth. Germany's economy is heavily dependent on global trade, though Ifo President Clemens Fuest noted that the German economy remained "stable, even if uncertainty is growing." Business confidence (to 103.7 from 103.9) barely budged this month after climbing in August for the first time since last November, reaching a six-month high. Of the four sectors—manufacturing, services, trade, and construction—overall confidence among manufacturing and trade companies remained around recent lows, while construction's continued to hit new record highs. Confidence in the service sector held in a volatile flat trend, at the top of its range. Meanwhile, Ifo indexes show little change for both the present situation (106.4 from 106.5) and expectations (101.0 from 101.3) measures, with the former showing little movement since falling from a record high of 108.8 in January to 106.3 in April. The expectations component retained most of August's 3.2-point gain—which was the biggest one-month increase since September 2009; the index had dropped steadily from a recent peak of 103.6 in November to a 29-month low of 98.1 by July. Ifo's expectations component correlates closely with German factory orders and production, while the overall index tracks exports more closely. Recent Ifo data suggest growth continues at a moderate pace. Meanwhile, September's flash estimate for Germany's M-PMI (to 53.7 from 55.9) shows growth in the manufacturing sector at a 25-month low this month.

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