



MORNING BRIEFING

October 3, 2018

Stocks Tracking Earnings Higher

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

(1) USAF and the S&P 500. (2) Bull market's jets fueled by earnings. (3) Remarkably strong revenues since mid-2016 still remarkably strong. (4) Could profit margins possibly go any higher? (5) What if the supply-side fairy tale comes true? (6) Animal spirits remain spirited. (7) Nothing to fear but wage inflation? (8) Powell says don't worry, be happy about higher wages. (9) Buybacks rose to record high during Q2.

Strategy I: Flying with the Blue Angels. "Off we go into the wild blue yonder" is the first line of the official song of the United States Air Force. It has also described the current bull market ever since it first rose to record-high territory on March 28, 2013. Since then, the S&P 500 is up 86.4% ([Fig. 1](#)). The S&P 400 rose to a record high on January 14, 2011 and is up 115.3% since then. The S&P 600 rose to a record high on March 31, 2011 and is up 134.3% since then. Let's have a closer look at this year's performance so far:

(1) *Record-high forward earnings.* After taking hits in early February, all three indexes continued to make record highs this year. Our Blue Angels analysis shows that they've been doing so by simply tracking their respective forward earnings, which were dramatically boosted by Trump's corporate tax cut at the end of last year ([Fig. 2](#)). All three forward earnings have been making record highs almost every week since then.

(2) *Reasonable valuations.* Both the S&P 500 and S&P 400 sported forward P/Es of about 18.0 at the start of the year, prior to the latest correction. Since the correction, both indexes have been rising along with their forward earnings, with their forward P/Es remaining around 16.0. The S&P 600's forward P/E dropped from 20.0 before the correction to 18.0 after it, and has held that level since as the index rose along with its forward earnings.

(3) *Remarkably strong revenues.* In addition to the tax cut, forward revenues for all three have also been bolstering forward earnings. Forward revenues per share for the S&P 500/400/600 are all on uptrends and in record-high territory ([Fig. 3](#)). For the S&P 500, industry analysts are estimating that revenues will increase 8.4% this year, 5.2% next year, and 4.1% in 2020.

As Joe and I have noted before, this year's strength in revenues is remarkable given that Trump launched a trade war earlier this year. Despite signs of weakness in emerging markets and sagging industrial commodity prices, S&P 500 forward revenues—which is a great coincident indicator of actual revenues—suggests that the global economy is weathering the storm remarkably well ([Fig. 4](#)). That, or weakness overseas has been more than offset by fiscal stimulus at home.

(4) *Even higher profit margins ahead?* So rising forward revenues are providing solid support for rising forward earnings. However, since the tax cut, forward earnings have greatly outpaced forward revenues ([Fig. 5](#)). As a result, the S&P 500 forward profit margin—which is a good coincident indicator of the actual quarterly series—has continued rising to a record 12.4% in late September ([Fig. 6](#)).

(5) *Wild animal spirits*. It's hard to believe that margins can continue to make new highs if labor costs start to increase significantly given the extreme tightness of the labor market. However, maybe the industry analysts all have turned into supply-side economists, betting that productivity will make a comeback that offsets, or at least reduces, the squeeze on profits from labor costs ([Fig. 7](#)). Joe and I are natural-born optimists and are open to the possibility that the supply-side fairy tale will come true.

We doubt that analysts are turning into supply-siders, though. Like us, they tend to be optimists, and are often forced to lower their revenues and earnings estimates as the time for the actual results approaches ([Fig. 8](#) and [Fig. 9](#)). However, their current unrelenting optimism suggests that they've been infected with animal spirits, just as measures of consumer and business confidence suggest has happened to the rest of us. (See our [Animal Spirits](#).)

(6) *Blue Angels heading higher into the wild blue yonder*. So where do we go from here? We think that the stock market will continue to make new record highs over the rest of the year. The S&P 500 is only 6.0% away from our 3100 target for the end of this year, which we predicted at the end of last year. That would be a 15.9% increase in 2018. For next year, our target is 3500, a 13% increase for 2019.

Earnings should continue to drive the market higher. We have often noted that the bull market has been a series of panic attacks followed by relief rallies. Recent record highs have been achieved on relief rallies triggered by news that Trump is winning his trade wars.

(7) *Nothing to fear but higher inflation*. Nevertheless, there is widespread concern that the tight labor market will cause wage inflation to soar, which would force the Fed to raise interest rates more aggressively. So the drop in initial unemployment claims to the lowest levels since 1969 is worrisome to some. We are in the bullish camp on this issue.

Our Boom-Bust Barometer (BBB)—which is the ratio of the CRB raw industrials spot price index to jobless claims—remains in record-high territory because the strength in claims offsets the recent weakness in the commodity index we use. Our BBB is highly correlated with S&P 500 forward index as well as the S&P 500 stock price index ([Fig. 10](#) and [Fig. 11](#)).

Reassuringly, in a [speech](#) yesterday, Fed Chairman Jerome Powell said: "As I mentioned, the FOMC carefully monitors a wide array of early indicators of inflation pressure to evaluate this risk. Wages and compensation data are one important source of information. These measures have picked up some recently, but in a way that is quite welcome. Specifically, the rise in wages is broadly consistent with observed rates of price inflation and labor productivity growth and therefore does not point to an overheating labor market. Further, higher wage growth alone need not be inflationary. The late 1990s episode of low unemployment saw wages rise faster than inflation plus productivity growth without an appreciable rise in inflation."

In other words, Powell is clearly saying: Don't freak out if Friday's employment report shows wage inflation moving higher. By the way, Amazon hiked its minimum wage to \$15 an hour yesterday. The company can afford it. Other companies that compete with Amazon probably can't raise prices and may see their profit margins squeezed if they are forced to raise wages too. Or else, they can scramble to boost their productivity.

Strategy II: Buybacks Binge. Back in February, Melissa analyzed Blue Chip company managements' comments about how their firms might use the unexpected windfalls that had just blown into their laps, courtesy of the Trump administration's Tax Cut and Jobs Act (TCJA) passed in December 2017. "Giddy" was how they collectively sounded as they surveyed their many options like kids in a candy

shop (see our 2/28 [Morning Briefing](#)).

Executives' first priority for use of the additional cash at that time seemed to be capital investment to support organic growth. Second came share buybacks and dividend increases to create shareholder value, followed by employee givebacks and letting the benefits drop directly to the bottom line. Whatever other moves they've made by now, seven months later, we know one thing for sure: They weren't kidding about buying back shares.

Joe reports that Q2-2018 was a quarter for the record books in terms of S&P 500 companies' share repurchases. S&P 500 quarterly buybacks edged up 0.8% q/q to a record-high \$190.6 billion during the quarter, and its 58.7% y/y gain was its strongest since Q1-2014 ([Fig. 12](#)). That \$190.6 billion is the highest quarterly buyback amount on record, dating back 82 quarters to Q1-1998; exceeds the prior cycle's record high of Q3-2007 by 10.9%; and represents an improved q/q for a fourth consecutive quarter. Notably, there haven't been four consecutive quarters of improvement in buyback amounts for nearly five years, since Q4-2013.

More slices and dices of the Q2 buyback data, courtesy of Joe:

(1) *That's some four-quarter sum!* The four-quarter sum of buybacks jumped 12.3% q/q to \$645.8 billion from \$575.3 billion in Q1-2018. That was its best pace since Q1-2014 ([Fig. 13](#)). The four-quarter sum hit a record high for the first time since Q1-2016's record of \$589.4 billion (which at the time was its first since Q4-2007).

(2) *Increased repurchase activity in more sectors than not.* Buybacks rose q/q during Q2-2018 for seven of the 11 sectors and fell for four ([Fig. 14](#)). That compares to seven rising and four falling during Q1-2018. The biggest q/q buyback gainers on a percentage basis in Q2-2018: Telecom (up 146.5% q/q to a 10-quarter high of \$419 million from \$170 million), Utilities (130.7%, to a 12-quarter high of \$413 million from \$179 million), Materials (41.8%, to a 10-quarter high of \$3.2 billion from \$2.3 billion), Industrials (40.9%, to a nine-quarter high of \$23.4 billion from \$16.6 billion), Consumer Discretionary (21.3%, to a three-quarter high of \$22.7 billion from \$18.7 billion), Tech (12.8%, to a record high of \$71.5 billion from \$63.4 billion), and Real Estate (0.1%, to \$884 million from \$883 million).

(3) *Repurchasing shares favored over hiking dividends.* During Q2-2018, the S&P 500 companies continued their long-established trend of spending more on buybacks than dividends, as record-high buybacks of \$190.6 billion outpaced the record-high quarterly dividend payments of \$111.0 billion. Buybacks have exceeded dividends in 42 of the past 47 quarters, except during the financial crisis from Q4-2008 to Q4-2009, when all sectors cut buyback spending drastically.

(4) *Cash returning to investors.* With the pace of buybacks and dividends rising in Q2, the four-quarter sum of buybacks and dividends, or cash returned to investors, improved for a fifth straight quarter to a record high of \$1.1 trillion from \$1.0 trillion during Q1. During Q2-2018, nine of the 11 sectors had enough operating earnings on a trailing-four-quarter basis to cover their buybacks and dividends (cash returned to investors), up from eight in Q1-2018.

CALENDARS

US. Wed: ADP Employment 177k, ISM & IHS Markit NM-PMIs 58.0/52.9, MBA Mortgage Applications, EIA Petroleum Status Report, Evans, Barkin, Mester. **Thurs:** Factory Orders 2.1%, Challenger Job-Cut Report, EIA Natural Gas Report, Quarles. (Econoday estimates)

Global. Wed: Eurozone Retail Sales 0.2% m/m/1.7% y/y, Eurozone, Germany, France, and Italy C-PMIs

54.2/55.2/53.6/51.8, Eurozone, Germany, France, and Italy NM-PMIs 54.7/56.5/54.3/52.8, UK C-PMI & NM-PMI 54.0/54.0, Japan C-PMI & NM-PMI. **Thurs:** None. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Buybacks ([link](#)): S&P 500 quarterly buybacks edged up 0.8% q/q to a record-high \$190.6 billion during Q2-2018, and its 58.7% y/y gain was its strongest since Q1-2014. The \$190.6 billion reading is the highest quarterly buyback amount on record, dating back 82 quarters to Q1-1998, and exceeds the prior cycle's record high of Q3-2007 by 10.9%. Furthermore, the quarterly buyback amount improved q/q for a fourth consecutive quarter for the first time since Q4-2013. The four-quarter sum of buybacks jumped 12.3% q/q to \$645.8 billion from \$575.3 billion. That was its best pace since Q1-2014. The four-quarter sum hit a record high for the first time since Q1-2016's record of \$589.4 billion, which at the time was its first since Q4-2007. S&P 500 buybacks in Q2 accounted for 0.83% of the total market capitalization for the S&P 500, down a whisker from Q1's eight-quarter high of 0.84%. That compares to 0.60% during Q4, which was the lowest since Q1-2010, as well as a cyclical peak of 1.15% in Q3-2011 and a record high of 1.28% during Q3-2007.

S&P 500 Sectors Buybacks ([link](#)): Buybacks rose q/q during Q1-2018 for seven of the 11 sectors and fell for four. That compares to seven rising and four falling during Q1-2018. The biggest q/q buyback gainers on a percentage basis in Q2-2018: Telecom (up 146.5% q/q to a 10-quarter high of \$419 million from \$170 million), Utilities (130.7%, to a 12-quarter high of \$413 million from \$179 million), Materials (41.8%, to a 10-quarter high of \$3.2 billion from \$2.3 billion). Industrials (40.9%, to a nine-quarter high of \$23.4 billion from \$16.6 billion), Consumer Discretionary (21.3%, to a three-quarter high of \$22.7 billion from \$18.7 billion), Tech (12.8%, to a record high of \$71.5 billion from \$63.4 billion), and Real Estate (0.1%, to \$884 million from \$883 million). The biggest percentage q/q decliners: Energy (-57.6%, to a three-quarter low of \$4.3 billion from \$10.1 billion), Health Care (-23.5%, to a two-quarter low of \$27.2 billion from a record high of \$35.6 billion), Financials (-11.3%, to a four-quarter low of \$30.0 billion from \$33.8 billion), and Consumer Staples (-9.3%, to a 36-quarter low of \$6.6 billion from \$7.3 billion). Tech accounted for the biggest portion of total S&P 500 buybacks in Q2-2018 for a third straight quarter, improving to a record-high 37.5% share from 33.5% in Q1. Tech had held the top spot for 16 straight quarters through Q3-2016 before trading places with Financials and Health Care for four quarters through Q3-2017. Financials' share was second despite falling to 15.7% from 17.9% in Q1, and Health Care's share was third, dropping to 14.3% in Q2 from 18.8% in Q1. Industrials' was fourth (up to 12.3% from 8.8%), and Consumer Discretionary's was fifth (up to 11.9% from 9.9%).

S&P 500 Cash Return & Buyback Yield ([link](#)): During Q2-2018, the S&P 500 companies continued their long-established trend of spending more on buybacks than dividends, as record-high buybacks of \$190.6 billion outpaced the record-high quarterly dividend payments of \$111.0 billion. Buybacks have exceeded dividends in 42 of the past 47 quarters, except during the financial crisis from Q4-2008 to Q4-2009, when all sectors cut buyback spending drastically. With the pace of buybacks and dividends rising in Q2, the four-quarter sum of buybacks and dividends, or cash returned to investors, improved for a fifth straight quarter to a record high of \$1.1 trillion from \$1.0 trillion during Q1. The four-quarter cash return rose 7.8% q/q and is up 19.1% from a nine-quarter low of \$906.7 billion during Q2-2017. It exceeded the prior record high of \$974.6 billion in Q1-2016 by 10.9%. On a brighter note, companies earned more than they paid out to investors for a sixth straight quarter after six straight quarters of earning less. More specifically, Q2-2018's four-quarter sum of operating earnings, at a record-high \$1.196 trillion, exceeded the \$1.080 trillion returned to investors. The cash return was 9.7% lower than trailing-four-quarter operating earnings during Q2, little changed from 11.3% during Q1 and compared to 5.2%, which was the best coverage ratio since Q3-2014. The S&P 500's Q2 figures are much better on an ex-Energy basis. Operating earnings exceeded the cash return for a seventh straight quarter as the percentage rose to 89.0% from 86.8%; it compares to a 28-quarter high of 102.2% in Q2-2016.

Including Energy, the S&P 500's buyback yield jumped to a seven-quarter high of 2.80% from 2.56%, and is up from a 31-quarter low of 2.28% in Q4-2017. The dividend yield edged down to 1.89% in Q2 from 1.90%, and was down even lower with the Q3 just released on Friday—to a 30-quarter low of 1.81%. Adding both Q2 figures together, the buyback + dividend yield (or cash return) jumped to a six-quarter high of 4.69% in Q2 from 4.46% in Q1.

S&P 500 Sectors Cash Return & Buyback Yield ([link](#)): During Q2-2018, nine of the 11 sectors had enough operating earnings on a trailing-four-quarter basis to cover their buybacks and dividends (cash returned to investors), up from eight in Q1-2018. Consumer Staples covered its cash return for the first time in 14 quarters, but the Energy sector missed for a 13th straight quarter. However, Energy was profitable on a GAAP operating earnings basis for a sixth quarter after five quarters of losses. Industrials covered its cash return for a fifth quarter after missing for seven straight quarters, Consumer Discretionary did so for a sixth quarter after missing for 12 quarters, Materials did so for just the seventh time in the 13 quarters since Q1-2014, and Tech did so for only the eighth time over that same time period. Here's how the sectors' four-quarter cash returns relative to four-quarter earnings ranked in Q2-2018: Real Estate (136.4%), Energy (119.3), Consumer Staples (98.8), Tech (92.4), Consumer Discretionary (91.8), S&P 500 (90.3), Health Care (89.9), S&P 500 ex-Energy (89.0), Financials (87.9), Industrials (86.3), Telecommunication Services (69.1), Materials (62.2), and Utilities (61.2). Looking at the four-quarter buyback + dividend yield, the percentage returns rose q/q for 7/11 sectors; here's how they ranked: Financials (5.97% [seven-quarter high]), Consumer Staples (5.62), Telecom (5.37), Industrials (4.98 [five-quarter high]), S&P 500 (4.69 [six-quarter high]), Tech (4.50 [six-quarter high]), Health Care (4.36 [five-quarter high]), Consumer Discretionary (4.18 [eight-year low]), Energy (4.16), Real Estate (3.96 [only the fifth quarter for which data is available]), Materials (3.59 [six-quarter high]), and Utilities (3.56).

US ECONOMIC INDICATORS

Auto Sales ([link](#)): Motor vehicle sales in September recovered to a high for this year, boosted by sales of domestic light trucks and imports. Total sales jumped to 17.4mu (saar) last month after slumping to a 12-month low of 16.7mu in August. (Sales had reached a 12-year high of 18.6mu last September—boosted by consumers' replacement of flood-damaged vehicles in areas hit by the hurricanes.) Domestic light truck sales climbed to 9.6mu (saar) last month, the best sales pace since July 2005 when they were boosted by aggressive discounts. Sales of imports accelerated from a 12-month low of 3.6mu in August to 3.9mu (saar) in September—just shy of May's reading of 4.0mu, which was the strongest pace since August 2009. Meanwhile, domestic car sales remained the weakest segment of the market, rising for only the second time in 12 months, ticking up from August's cyclical low of 3.8mu to 3.9mu (saar) last month. These sales have been in a virtual freefall since peaking at 6.1mu (saar) during August 2014.

GLOBAL ECONOMIC INDICATORS

Japan Consumer Confidence ([link](#)): Consumer confidence in September increased for only the second time this year, though remains near recent highs. It ticked up to 43.4 last month after sinking the prior three months from 43.8 in May to a 12-month low of 43.3 in August. Still, it's not far from the four-year high of 44.6 posted from November through January. Two of the four sub-components moved higher this month—willingness to buy durable goods (42.4 from 42.0) and income growth (41.9 from 41.8)—while overall livelihood (41.5 from 41.7) edged lower and employment (47.7) held steady. All four measures remained at relatively high levels.

Contact us by [email](#) or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-775-6823

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