



MORNING BRIEFING

October 4, 2018

On the Road Again

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

(1) Why have rail stocks been leaving trucking stocks in the dust? (2) Business is brisk for both, but labor costs and fuel-efficiency favor rails. (3) Amazon materializes, bursting into the “real” world with stores, smart homes, and delivery trucks (for starters). (4) Internet retail industry is a projected 80% 2018 earnings grower valued at a forward P/E in the 50s—add to cart? (5) Elon Musk, Houdini of the business world, escapes from self-made scrapes again. (6) Tesla says it met Q3 production goals—defying critics.

Transports: A Fork in the Road. A few weeks ago, the [Morning Briefing](#) highlighted the market's latest rotation: Safety sectors Utilities, Health Care, and Telecom are in rally mode. They had been trouncing the performance of the Tech sector, the previous market leader, until the past few days when risk-on sectors made a comeback and the bond yield rose above 3.10%.

This week, another divergence caught our attention: Since June 12, the S&P 500 Railroad stock price index has climbed 12.0%, while the S&P 500 Trucking stock price index has been in reverse, falling 8.0% ([Fig. 1](#)). That 20ppt gap in performance is all the more interesting because the S&P 500 Trucking index, comprising only JB Hunt, had been outperforming the railroads for much of the first half of the year.

The Railroad industry accounts for 46.0% of the market cap of the S&P 500 Transportation index, which has been chugging along into record-high territory along with the Rails this year ([Fig. 2](#)). The Transports index is up 8.9% ytd through Tuesday, while the S&P 500 is up 9.3%. Let's have a closer look at what's happening on the rails, on the roads, and at the ports:

(1) *Driven by strong profits.* Analysts expect that the Railroad and Trucking industries will have strong revenue and earnings growth both this year and next. The former is expected to increase revenues by 7.1% this year and 4.4% in 2019, and its earnings are forecast to jump 39.1% in 2018 and 12.4% in 2019 ([Fig. 3](#) and [Fig. 4](#)).

The numbers in the Trucking index are also strong: Revenue is expected to grow 19.7% this year and 10.5% in 2019, earnings 51.1% this year and 19.1% next ([Fig. 5](#) and [Fig. 6](#)).

(2) *Lots of stuff moving.* The railroads and truckers certainly have plenty of freight to transport. Business sales of goods, adjusted for inflation, rose 2.6% y/y in July to another record high ([Fig. 7](#)). Despite Trump's trade war, West Coast ports' total container traffic—both inbound and outbound—climbed 4.0% y/y in August into record-high territory ([Fig. 8](#)).

Railcar loadings are up 4.7% y/y, continuing the rebound that started in early 2016 ([Fig. 9](#)). The industry looks even healthier if carloadings of coal are excluded ([Fig. 10](#)). The use of coal by utilities has dropped sharply in recent years, as it became more cost effective to burn inexpensive natural gas. Conversely, the industry has been helped by a surge in railcar loadings since early 2016 of chemicals

and petroleum products mostly attributable to the fracking industry ([Fig. 11](#)).

During August, the ATA Truck Tonnage Index dipped 1.8% m/m, but rose 4.5% y/y, according to the American Trucking Associations' [press release](#) ([Fig. 12](#)). It remains solidly in record-high territory.

(3) *Labor-cost divergence*. The divergence in the recent performance of the Railroads and the Trucking industries may be attributable to the greater labor intensity involved with trucking. At a minimum, there's one person per truck. Trains, on the other hand, are able to move more than 100 railcars with one to two people on the job.

The difference may go far in explaining the large divergence between the two industries' profit margins. The railroad industry has an enviable estimated profit margin of 24.6% this year, which is forecast to improve to 26.5% in 2019 ([Fig. 13](#)). Those margins are much more attractive than the 6.9% operating margin expected this year and 7.4% targeted next year for the S&P 500 Trucking industry ([Fig. 14](#)).

Both industries are facing a tight labor market. The latest sign of stress was laid out in a 10/1 [WSJ article](#): "Truck drivers and Teamsters union members picketed at freight-handling sites in Southern California on Monday, calling on companies to convert independent-contractor drivers to full-time employees."

(4) *Fuel-efficiency divergence*. Truckers may also be underperforming their rail counterparts because the price of oil has spiked ytd and truckers are notoriously less fuel efficient than railroads. A barrel of Brent crude oil has jumped to \$84.80, up 27% from the start of the year ([Fig. 15](#)).

The jump in oil prices has a much larger impact on the truckers. "Moving freight by rail is four times more fuel efficient than moving freight on the highway," according to the CSX [website](#). A CSX train can move a ton of freight 471 miles on a gallon of fuel, according to 2015 data, vs just 134 miles for a truck.

The divergence may continue until either electric, automated trucks are introduced or a recession comes along.

Amazon: Bricks Over Clicks? Amazon is an amazing amalgamation of technology and retailing. As the world's largest Internet retailer, a major provider of cloud computing services, and developer of Alexa, no one can doubt the company's tech bonafides. However, recent headlines have highlighted Amazon's aggressive expansion into the physical world of bricks and mortar.

Amazon announced on Tuesday its warehouse workers' wages will be bumped to \$15 an hour, a move that will pressure other retailers to boost their starting wages as well. In the last month, it has been reported that Amazon may open 3,000 convenience stores and that it has invested in a prefab housing manufacturer. Let's take a look at the recent pronouncements that accelerate the melding of click and bricks:

(1) *Stores made of bricks*. Amazon's expansion into the "real" world accelerated last year when the company purchased Whole Foods' 470 grocery stores. The same year, Amazon began opening book stores, which now number roughly 20. And last week, the company launched a novelty store concept, 4-Star, which is stocked with goods that have at least four-star customer ratings on Amazon.com (note to Jeff Bezos: Save shelf space for [Predicting the Markets!](#)).

Still under consideration: the rollout of AmazonGo—its urban convenience store concept—to 3,000 locations by 2021, according to a 9/19 Bloomberg [article](#). The company currently has just two AmazonGo stores that offer grab-and-go food, like sandwiches and salads, and another two that stock

groceries as well. Adding 2,996 stores would mean a lot of bricks.

At AmazonGo, customers enter by scanning their phones at a turnstile, grab the desired goods, and exit without having to pay a cashier. Sensors note what shoppers take and bill them directly. “The challenge to Amazon’s plan is the high cost of opening each location. The original AmazonGo in downtown Seattle required more than \$1 million in hardware alone, according to a person familiar with the matter,” the Bloomberg article stated.

The company that made grocery store and book store operators quake now has a target on convenience stores, like 7-11, and fast-food eateries, like Subway and Panera.

(2) *Homes, sweet homes.* Amazon also entered the home-building business last month, presumably with an eye toward filling its newly built homes with its Alexa-powered smart home devices. The Internet retailer invested in a home-building startup, Plant Prefab, through its Alexa Fund. Amazon has given the Alexa Fund \$200 million since it launched in 2015 to invest in companies, at home and abroad, that integrate its Alexa Voice Services into their products.

Plant Prefab “says it uses sustainable construction processes and materials to build prefabricated custom single- and multifamily houses. The start-up is aiming to use automation to build homes faster and bring down costs,” according to a 9/25 CNBC [report](#). It hopes to reduce construction time by 50% and reduce cost by 10%-25% in major cities.

This announcement comes after Amazon struck a separate deal with Lennar to pre-install Alexa in each of the 35,000 smart homes that Lennar expects to build this year. (Now that’s a REAL lot of bricks!)

(3) *Bricks with wheels.* Product delivery may not be cool by tech wizard standards, but Amazon certainly has its eye on the real-world problem of transporting goods over the last mile to customers’ homes. The company announced early last month that it will order 20,000 new Mercedes-Benz Sprinter vans for its delivery program.

The vans will be owned by fleet-management companies that will buy the vehicles and lease them to small delivery service providers, a 9/5 *WSJ* [article](#) reported. Amazon had previously announced its plans to invite entrepreneurs to create delivery companies—which each could employ up to 100 drivers and lease between 20 and 40 vans sporting the Prime logo—to handle Amazon deliveries. The company says it has received tens of thousands of applications. FedEx and UPS are undoubtedly watching closely.

(4) *Amazing growth.* The S&P 500 Internet & Direct Marketing Retail industry, in which Amazon resides, is expected to continue its rapid growth both on the top and bottom lines. Revenues are forecast to jump 28.9% this year and 20.3% in 2019 ([Fig. 16](#)). Earnings are forecast to improve even more rapidly: 79.5% in 2018 and 30.1% next year ([Fig. 17](#)). The industry’s forward P/E, at 54.6, is down from its peak of 85.8 at the start of the year and from 62.4 just a week ago, before Netflix was transferred into the newly created Communication Services sector ([Fig. 18](#)).

Tech: Elon Houdini. Harry Houdini was renowned for his ability to defy the odds and escape from tight spots of his own making. He escaped from the belly of a whale’s carcass despite being wrapped in chains. He could swallow 100 needles and 20 yards of thread. And who can forget the well-photographed image of Houdini in a strait jacket and chains, hanging upside down from a building crane?

Elon Musk in recent weeks attracted gawkers wondering how he’d get out of his self-made

predicaments. He tweeted his intention to take Tesla private and followed that with smoking pot during a podcast. Musk's tweet prompted securities fraud charges by the Securities & Exchange Commission (SEC), which he first fought but then settled this week. Musk didn't escape completely unscathed. He has to step down as Tesla's chairman and add two independent directors to the board, and he and the company each has to pay a \$20 million fine. But at least he was able to remain Tesla's CEO.

The SEC settlement capped a week of good news. Tesla hit Q3 production goals. Norway is adopting electric cars at an amazingly fast pace. And Musk's vision of a hyperloop took a large step toward becoming a reality. Here's a quick rundown:

(1) *Delivery goal hit.* Tesla hit its Q3 production goals. "Deliveries totaled 83,000 vehicles, of which 55,840 were Model 3s. ... Analysts polled by FactSet had expected Tesla to deliver about 80,000 vehicles in the quarter including 55,000 Model 3 sedans," a 10/3 MarketWatch [article](#) reported. The news was even more impressive given that most traditional auto players saw their monthly sales decline in September. Now analysts await the company's earnings release to see if Tesla can deliver on its promises to be profitable and cash-flow positive in Q3 and Q4.

(2) *Norway loves EVs.* Electric vehicle (EV) sales in Norway hit record levels in September. For the month, 45% of new passenger cars registered were all-electric vehicles, and 60% were either electric or plug-in hybrids, a 10/1 [article](#) in Elektrik reports.

Granted, the absolute number of total cars sold in Norway, 10,620, is far smaller than the number sold in the US. However, the quick uptake of electric cars is notable nonetheless, and makes the country's goal of all new cars being electric by 2025 potentially achievable— if the country continues its policy of juicy incentives.

A 7/2 [article](#) in *The Guardian* laid out the benefits of buying an EV in Norway: Motorists escape heavy import and purchase taxes. They're exempt from a 25% value-added tax, aren't subject to road taxes, and have no drive-by road tolls. Electric car drivers get free municipal parking, free charging, and can often use bus lanes. Ironically, Norway pays for these incentives with the proceeds it receives from selling its oil.

Norway's perks have been enough to prompt residents to buy EVs as a second car, and in time we'll see if they can let go of their gas-guzzling autos entirely. The move to EVs is occurring despite the limited options buyers have. The Model 3 and Audi's e-tron aren't yet available in Norway. However, Tesla did sell roughly 2,000 of its older models in the green country last quarter.

(3) *Hyperloop excitement.* Musk touted the potential of a hyperloop in 2013, and this week his vision got one step closer to becoming a reality. Hyperloop Transportation Technologies—a company unrelated to Musk—unveiled its first full-scale passenger capsule intended for use in a hyperloop, a 10/2 CNBC [article](#) reported.

A hyperloop would theoretically move passengers in train-like capsules through low-pressure tubes at more than 750 miles per hour. It would provide a speedy alternative to our clogged highways and pokey train system. The capsule was shown in Spain and will be moved to California, where it can be used on one of the first commercial tracks.

All in all, Musk had a good week, defying his many critics by escaping from a number of tricky situations. But given his track record, we'd be prepared for more Musk drama in the future.

CALENDARS

US. Thurs: Factory Orders 2.1%, Challenger Job-Cut Report, EIA Natural Gas Report, Quarles. **Fri:** Total, Private, and Manufacturing Payroll Employment 180k/175k/10k, Unemployment & Participation Rates 3.8%/62.7%, Average Hourly Earnings 0.3%*m/m*/2.9%*y/y*, Average Workweek 34.5hrs, Merchandise Trade Balance -\$53.7b, Consumer Credit \$15.0b, Baker-Hughes Rig Count, Bostic. (Econoday estimates)

Global. Thurs: None. **Fri:** Germany Factory Orders 0.8%*m/m*/-3.0%*y/y*, Canada Employment Change & Unemployment Rate 30k/5.9%, Japan Leading & Coincident Indexes 104.2/117.4, Australia Retail Sales 0.3%. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators ([link](#)): Our Bull/Bear Ratio (BBR) climbed this week for the eighth time in nine weeks, from 2.90 to 3.32 over the period, to its highest reading since mid-March. Bullish sentiment rose 7.3ppts (to 61.8% from 54.5%) over the nine-week period, while the correction count fell -7.1ppts (19.6 from 26.7). The former was at its highest reading since the end of January, while the latter was at its lowest since mid-February 2012. Meanwhile, bearish sentiment was once again little changed, ticking up to 18.6% this week; it has fluctuated in a narrow band between 17.6% and 18.8% the past 18 weeks. The AAI Ratio advanced for the second week to 53.8% last week after sliding from 64.0% to 49.4% the prior two weeks. Bullish sentiment rose to 36.2% last week after falling the prior three weeks from 43.5% to 32.0%, while bearish sentiment fell for the second week to 31.1%, following a two-week rise from 24.4% to 32.8%.

S&P 500 Earnings, Revenues & Valuation ([link](#)): S&P 500 consensus-per-share forecasts for forward revenues and earnings rose to record highs again last week. As more weight is placed on the lower 2019 *y/y* growth expectations for revenues and earnings, their forward growth rates will continue to fall. Analysts expect forward revenues growth of 5.8% and forward earnings growth of 12.5%, down from 12.6% a week earlier. Forward revenues growth is little changed from an 80-month high of 6.3% at the end of February, but forward earnings growth is down to an eight-month low from 16.9% in February, which was the highest since October 2010. Forward revenue growth was 5.5% prior to the passage of the TCJA, and forward earnings growth was 11.1% then. Turning to the annual revenue growth expectations, the forecasts remained steady *w/w* at 8.4% for 2018 and 5.2% for 2019. Looking at annual earnings growth, the 2018 forecast edged down 0.1ppt to 23.0%, and the 2019 forecast was steady at 10.3%. The forward profit margin edged down 0.1ppt to 12.3% from the prior week's record high of 12.4%, which is up from 11.1% prior to the passage of the TCJA in December and from a 24-month low of 10.4% in March 2016. The S&P 500 ex-Financials forward growth forecasts were steady *w/w* at 6.0% for revenues and 12.2% for earnings. The S&P 500 ex-Financials forward profit margin edged down 0.1ppt to 11.4% from a record high of 11.5%, which is up from 10.4% before the TCJA. Valuations were mixed *w/w*, but remain near the highest levels since mid-March. The S&P 500's forward P/E was unchanged at 16.9, which compares to a 16-year high of 18.6 at the market's prior peak in late January and its recent low of 16.0 in early May. The S&P 500 price-to-sales ratio was down to 2.08 from 2.09, which compares to late January's record high of 2.16 and early May's low of 1.95.

S&P 500 Sectors Earnings, Revenues & Valuation ([link](#)): Consensus forward revenue forecasts rose *w/w* for nine of the 11 of the S&P 500 sectors, but forward earnings rose for only four: Consumer Staples, Energy, Real Estate, and Tech. The per-share measures for both forward revenues and earnings are at or around record highs for 4/11 sectors: Consumer Discretionary, Health Care, Industrials, and Tech. Forward margins are at record highs for 8/11 sectors, all but Energy, Health Care, and Real Estate. Energy's forward revenues and earnings are back on uptrends after stalling

during 2016-2017, and its earnings has about tripled from the 18-year low in April 2016. Forward P/S and P/E ratios remain below their recent highs in early 2018 for all sectors. Energy's valuations remain elevated relative to historical levels, but are slowly returning to normal now after soaring in 2016 when revenues and earnings collapsed. Energy's P/S ratio of 1.24 compares to a record high of 1.56 in May 2016, and its P/E of 16.4 is down from a record high of 57.5 then. Due to the TCJA, higher margins are expected y/y in 2018 for all sectors but Real Estate, but that sector's forward earnings includes gains from property sales and typically improves as the year progresses. During the latest week, the forward profit margins rose or fell for 8/11 sectors. Notably, the revamped Communications Services sector surged 1.4ppts, Consumer Discretionary fell 0.7ppt, and Tech dropped 0.2ppt. Here's how the sectors rank based on their current forward profit margin forecasts: Information Technology (22.8%), Financials (18.9), Real Estate (16.1), Communication Services (15.4), Utilities (12.7), S&P 500 (12.3), Materials (11.2), Health Care (10.6), Industrials (10.2), Consumer Discretionary (7.4), Consumer Staples (7.5), and Energy (7.6). Energy's forward profit margin is near the highest level since December 2014. Among the remaining 10 sectors, all but two (Real Estate and Health Care) are at or near recent record highs.

US ECONOMIC INDICATORS

ADP Employment ([link](#)): In September, private industries added a larger-than-expected 230,000 to payrolls, 53,000 above the expected 177,000 gain, and only the second increase above 200,000 in seven months. There was a small upward revision of 6,000 to August (to 169,000 from 163,000) payrolls, and a small downward revision of -6,000 to July's (211,000 from 217,000). According to the report, "The job market continues to power forward. Employment gains are broad-based across industries and company sizes. At the current pace of job creation, unemployment will fall into the low 3%'s by this time next year." Last month, employment in service-providing industries rose 184,000, while goods-producing's level climbed 46,000—both accelerating from gains of 145,000 and 23,000, respectively, in August. Latest data show construction companies added 34,000 to payrolls, matching its best gain this year, while factories added 7,000—its poorest performance since last July; over the past 22 months, construction and manufacturing employment is up 401,000 and 342,000, respectively. Within service-providing industries, the increase was broad based, with professional & business services (70,000), education & health services (44,000), and trade, transportation & utilities (30,000) leading the pack. By company size, medium-sized companies (99,000) remained at the top of the leader board, accounting for just over 40% of September's gain, with 71,000 service-providing and 27,000 goods-producing. Large companies held the second position, adding 75,000 jobs—with service-providing (71,000) companies accounting for nearly the entire gain. Small companies remained in the cellar, adding 56,000 to payrolls—a seven-month high—with the mix 42,000 service-providing and 14,000 goods-producing.

GLOBAL ECONOMIC INDICATORS

Eurozone Retail Sales ([link](#)): August retail sales fell for the second month since reaching a new record high in June. Sales fell -0.2% after a revised -0.6% decline in July—which was steeper than the initial -0.2% loss. Sales for both automotive fuel and food, drinks & tobacco fell for the second straight month, by a total of -2.1% and -1.3%, respectively. Spending on non-food products excluding fuel was flat following a -0.1% downtick in July. Over the past 12 months, sales of non-food products ex fuel (1.4% y/y) and food, drinks & tobacco (1.1) rose, while automotive fuel (-0.2) was basically flat. August sales are available for three of the Big Four economies, with sales in both Germany and France falling for the second month by a total of -1.2%, while Spain's gained 0.6% after a -0.9% loss in July. Meanwhile, among the Eurozone economies for which data are available, the largest decreases in the total retail trade volume were registered in Latvia (-1.2%) and France (-0.7), while the highest increases were observed in Portugal (1.1), Ireland (1.0), and Slovenia (1.0).

Global Composite PMIs ([link](#)): Global economic activity slowed to a two-year low in September. The JP Morgan Global Composite Output Index (C-PMI) fell for the third month to 52.8 last month, after climbing the prior three months from 53.3 in March to 54.2 in June—which wasn't far from February's 3.5-year high of 54.8. The NM-PMI slipped to a 23-month low of 53.0 in September after advancing steadily from 53.2 in March to 54.6 in June. Meanwhile, the M-PMI fell for the eighth time this year, sinking from 54.5 in December to a 22-month low of 52.2 last month. The Eurozone's C-PMI (to 54.1 from 54.5) shows it replaced the US (53.9 from 54.7) as the main driver of the global economic expansion last month, by a very small margin, with the former slowing to a four-month low and the latter to an eight-month low. Within the Eurozone, Ireland's C-PMI (58.4, unchanged from August's 7-month high) once again topped the leader board—followed by those of Germany (55.0, 2-month low), France (54.0, 21-month low), Spain (52.5, 58-month high), and Italy (52.4, 2-month high)—with only Italy showing a slight improvement. Meanwhile, C-PMIs show growth accelerated in Russia (53.5 from 52.1), virtually matched August's pace in the UK (54.1 from 54.2), and slowed to a two-year low in Japan (50.7 from 52.0); Brazil's (47.3 from 47.8) continued to contract. (Note: Due to later than usual release dates, September 2018 manufacturing PMI data for Australia and services data for China, India, and Australia were not available for inclusion in the global numbers.)

Global Non-Manufacturing PMIs ([link](#)): The global service sector in September grew at its slowest pace since October 2016, despite an uptick in new orders. JP Morgan's NM-PMI fell for the third month, to 53.0 last month, after climbing from 53.2 in March to 54.6 in June—which was the second-highest rate of the past three years—February's 54.8 being the highest. National PMI data highlighted the Eurozone as a bright spot for the global service economy, with its NM-PMI (to 54.7 from 54.4) accelerating at its quickest pace in three months, as stronger growth was recorded in Germany (55.9 from 55.0), Italy (53.3 from 52.6), and Ireland (58.7 from 58.0), while growth slowed in France (54.8 from 55.4) and Spain (52.5 from 52.7). Outside the Eurozone, C-PMIs for the US (53.5 from 54.8) and UK (53.9 from 54.3) saw slower growth, while Japan's (50.2 from 51.5) was only marginally above stagnation. Brazil's (46.4 from 46.8) saw output contract for the second successive month, with the rate of decline the steepest since February 2017. (Note: September 2018 survey data for Australia, China, and India were not available for inclusion in the global numbers.)

US Non-Manufacturing PMIs ([link](#)): The ISM measure shows growth in the service sector accelerated at its fastest pace in more than two decades, while the IHS Markit measure dipped to an eight-month low. ISM's NM-PMI rebounded to 61.6 last month, its first reading above 60.0 since August 2005—and the highest since August 1997! All four components of the NM-PMI accelerated for the second month, with NM-PMIs for business activity (65.2 from 60.7) and new orders (61.6 from 60.4) moving further above 60.0 last month—with the former the highest since January 2004. The employment (62.4 from 56.7) measure jumped to a new record high, while the supplier deliveries (57.0 from 56.0) gauge moved back toward recent highs. IHS Markit's NM-PMI fell for the fourth month since reaching a three-year high of 56.8 in May, slipping to 53.5 last month, though the Q3 average (54.7) was strong overall. According to the report, "Reassuringly, the rate of new business growth picked up in September, moving closer to the strength seen earlier in the year. The sharp upturn in new orders was commonly attributed to improved client demand." Meanwhile, hiring increased at the joint-quickest rate since June 2014.

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