



MORNING BRIEFING

October 11, 2018

Respecting the Tape

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

(1) Triple whammy: rising interest rates, oil prices, and the dollar. (2) China's spooks are spooking supply chains. (3) Trump stepping on accelerator and brakes at the same time. (4) Bad vibrations in auto industry. (5) Homebuilding has the shakes. (6) Building overcapacity in hotel industry. (7) Canary is gasping in the copper mine. (8) Too much capacity in semi equipment industry. (9) Mind reading.

Strategy I: The Witching Season. The S&P 500 is down 4.9% from its record high on September 20. It was an especially bad day for the index yesterday, as it dropped 3.3%. Stocks have been struggling ever since the 10-year US Treasury yield jumped decisively above 3.00% on October 3. That's bad news for interest-sensitive consumer-related stocks, as Jackie and I discuss in the next section.

However, the recent selloff isn't just about rising interest rates. The price of a barrel of Brent crude has been soaring ever since President Trump withdrew from the Iran nuke accord on [May 8](#), and moved to impose sanctions on the country. While that's good for energy companies and their stocks, it's bad news for consumers and businesses that have to pay more for fuel.

Furthermore, while Trump seems to be winning his trade wars with most of America's major trading partners, the conflict with China is likely to worsen because it isn't just about trade. It is about national security. That's raising alarms, particularly among US technology companies that have integrated China into their supply chains. News that the country's spooks have been planting spyware into widely used motherboards only heightens the national security concerns.

Rising interest rates, higher oil prices, and a strong dollar are a triple whammy for emerging market economies. The fear is that while the US economy has been supercharged by Trump's tax cuts, it may not decouple for long from the slowdown overseas.

The rally since early February may be stalling out on confusion about Trump's policies. He seems to be stepping on the accelerator and brakes at the same time. Deregulation and tax cuts are bullish for the US economy as well as for corporate earnings and stock prices. On the other hand, the ballooning federal deficit attributable to the tax cut and spending increases is putting upward pressure on bond yields, at the same time that the Fed has moved to raise interest rates and taper its balance sheet.

A prolonged trade war with China may disrupt supply chains, but is more likely to depress China's economy as manufacturers around the world isolate their supply chains from China.

The bottom line for us: We've been flagging these concerns in recent weeks, but still don't expect them to cause a recession in the US. We remain bullish on the outlook for earnings, and expect the market to recover and make new highs going into next year. October can be a wicked month; Halloween started early this month for investors. Nevertheless, we are monitoring the bearish market signals discussed in the following section.

Strategy II: Market Signals. If you believe the stock market is a discounting mechanism—pricing in today what it forecasts will happen six months in the future—then Mr. Market may be worried that an economic slowdown will arrive in 2019. The stock price indexes of certain industries that led the market up over the past few years are solidly in negative territory this year.

Consider the performance of the following S&P 500 industries ytd through Tuesday's close: Copper (-30.5%), Homebuilding (-27.1), Automobile Manufacturers (-24.2), Semiconductor Equipment (-23.4), Paper Packaging (-22.4), and Hotels, Resorts & Cruise Lines (-6.6). Some of these industries take the pulse of the consumer. Others home in on the health of manufacturing. All may be reacting badly to rising interest rates and oil prices.

Another factor unites these disparate industries: Most have added capacity in recent years and now are either experiencing or fearing declines in the prices of their end products.

In any event, these industries' share price gains in recent years shored up our confidence to remain bullish, so their downward movement is reason for concern. In an effort to "respect the tape," let's take a deeper look at what the stock price action of these industries could be saying:

(1) *Driving in reverse.* Given the strength in the job market and the overall economy, auto sales should be on fire. Instead, they've been stagnating at flat-to-slightly-down levels in 2018. The 12-month sum of US motor vehicle sales peaked at 17.7 million units during February 2016, and it came in at 17.4 million in September ([Fig. 1](#)). Not even a sharp rise in the domestic light truck market has been enough to offset the decline in domestic car purchases ([Fig. 2](#)).

Buyers apparently are opting to buy used cars, according to a 9/23 *WSJ* [article](#): "The gap between the price of a new and used vehicle is as wide as it has been in years, pushing an increasing number of consumers to the used-car lot and putting pressure on auto makers to deepen discounts on new cars to keep them competitive. ... Used-car buyers are finding a growing selection of low-mileage vehicles that are only a few years old," thanks to the leased cars being returned to dealerships.

Were that not enough, the industry has had to deal with additional costs relating to steel tariffs, which went into effect on July 1. General Motors and Ford are also facing the expense of developing electric and autonomous cars, as industry upstarts—including Tesla, Waymo, and Uber—aim to disrupt the industry.

The S&P 500 Automobile Manufacturers stock price index has fallen 24.2% ytd ([Fig. 3](#)). The index basically has traded sideways for much of the last eight years after bouncing off 2009 lows. The industry is expected to grow revenue by 0.2% this year, but revenue is expected to drop next year by 0.2% ([Fig. 4](#)). Analysts have been trimming earnings estimates over the past two months and now expect the industry to have a 16.8% decline in earnings in 2018, followed by a 0.4% increase next year ([Fig. 5](#) and [Fig. 6](#)).

The industry has a very low forward P/E, 6.2. However it's a cyclical industry, so it's often best to buy when P/Es are high and earnings are depressed.

(2) *No more vacations?* Consumers' willingness to go on vacation is one of the indicators we've watched to confirm the economy's health. And while data on hotel rooms still look positive, the stocks are acting pretty awful, primarily on concerns about too much future supply and rising costs.

On the surface, all looks fine, as the industry has enjoyed strong results this year. Most recently, US

hotel occupancy rose 1.7% y/y to 71.5%, and the average daily rate jumped 7.3% to \$137.31 during the week of September 23, according to a 10/4 [article](#) on Hotel News Now. Revenue per available room rose even faster, 9.1% to \$98.15.

One concern is inflation, particularly if low-wage employees push for raises. “The real wild card is labor costs,” said Jan Frietag, senior vice president for research firm STR, in a 8/27 [article](#) in *National Real Estate Investor*. “I don’t worry about the U.S. hotel industry’s ability to put heads in beds. I worry about its ability to make the beds.”

Another issue is supply, which is being added at record levels. “[T]otal global construction pipeline stands at 12,839 projects/2,158,422 rooms which are at all-time highs. The construction pipeline is up an extraordinary 86% by projects over the cyclical low established in 2011 when global counts were at 6,907 projects/1,257,296 rooms,” according to a 9/21 [report](#) by Lodging Econometrics. In the US, nonresidential construction of lodging is at its highest levels in nearly a decade ([Fig. 7](#)).

Supply is also dogging the cruise industry. There are 13 new cruise ships slated for delivery this year, 25 in 2019, 19 in 2020 and 20 in 2021, according to [data](#) in *Cruise Industry News*. Those orders are up sharply from 2017, when 10 ships were delivered.

Investors aren’t waiting around to see the impact of additional supply. The S&P 500 Hotels, Resorts & Cruise Lines stock price index is down 6.6% ytd ([Fig. 8](#)). But forecasts remain optimistic, with revenues targeted to grow 1.9% this year and 7.2% in 2019, and earnings set to increase by 22.5% and 11.2% ([Fig. 9](#) and [Fig. 10](#)). Meanwhile, the industry’s forward P/E has fallen from a high of 19.6 this year to a more reasonable 15.9.

(3) *Canary in the copper mine?* Despite the US economy’s strength, the prices of numerous key commodities have fallen this year. Dragged down by a strong dollar and the slowdown in the Chinese economy, the price of copper has dropped 12% ytd, and the CRB raw industrials spot price index is 8% lower ([Fig. 11](#)).

The sharp drop in copper prices has weighed on the S&P 500 Copper stock price index, which is down 30.5% ytd ([Fig. 12](#)). The industry’s revenues are forecast to surge 15.5% this year, only to drop 18.6% in 2019. Likewise, analysts see earnings jumping 53.9%, only to tumble 43.2% next year ([Fig. 13](#) and [Fig. 14](#)).

(4) *Fading paper profits.* The picture in the S&P 500 Paper Packaging industry is a bit murkier. The industry should be flying, given strong consumer spending and the number of packages on doorsteps; however, the index has fallen 22.4% ytd ([Fig. 15](#)).

Here too, there’s some concern about the industry’s ability to absorb new capacity. Nine Dragons Paper Holdings, a Chinese manufacturer of containerboard products, purchased two existing paper mills in the US, which it intends to expand, according to a 5/26 [article](#) in the *South China Morning Post*. US manufacturers have also expanded capacity. That was enough to prompt BMO Capital Markets analyst Mark Wilde to downgrade a number of the industry’s stocks.

“Demand growth has slowed despite a strong macro economy, and industry leaders will be forced to fight to maintain pricing while protecting market share from smaller players looking to steal small amounts of market share,” Wilde said, according to a 10/9 [article](#) on Benzinga. “It’s unclear how all the new capacity will be absorbed, and the analyst’s supply-demand model calls for operating rates to fall from 97.5 percent in 2017 to 90.9 percent by 2021.” Meanwhile, the price of recycled paper has plummeted as China has stopped accepting used paper.

So far, financial forecasts for the Paper Packaging industry have held up. Revenues are expected to increase 8.3% this year and 2.9% in 2019, while earnings soar 43.5% and 9.7%, respectively ([Fig. 16](#) and [Fig. 17](#)). Because stock prices have fallen but earnings have held up, the industry's forward P/E has dropped to 11.1, a level last hit in 2015 before the industrial slowdown of 2016 ([Fig. 18](#)).

(5) *Semi equipment stalls*. Shares in the semiconductor equipment industry have dropped sharply on concerns that the robust spending on semi equipment in recent years is slowing. These fears were reinforced this summer on reports that Samsung and Taiwan Semiconductor Manufacturing “seemed to be trimming their outlays again,” an 8/18 *WSJ* [article](#) reported.

Capacity issues may escalate as China makes good on its aim to enter the semiconductor industry. Foxconn Technology Group is partnering with a local government in China's Pearl River Delta to build a chip fabrication plant, according to an 8/17 *WSJ* [article](#), which can only exacerbate excess capacity in the industry.

The S&P 500 Semiconductor Equipment stock price index has fallen 23.4% ytd ([Fig. 19](#)). The industry's revenues are expected to swing from a 24.3% increase this year to a 1.9% decrease in 2019 ([Fig. 20](#)). Likewise, its earnings are forecast to grow 48.3% this year, only to decline 5.8% in 2019 ([Fig. 21](#)). The industry's forward P/E has fallen to 9.7, a level last seen during the years shortly after the recession ([Fig. 22](#)).

Technology: Mind Blowing. Scientists are working on ways we can chat without saying or writing a word. Scientists at the University of Washington have linked humans' brains and enabled them to communicate while in different rooms. The experiments began in 2013 and have become more sophisticated over the years; a video of a 2013 pilot study showing direct brain-to-brain communication can be seen [here](#).

Two years later came the first experiment showing “that two brains can be directly linked to allow one person to guess what's on another person's mind,” a 9/23/15 [press release](#) by the University of Washington explained.

This experiment was taken one step further this year, creating a network of brains, or a BrainNet, by connecting three subjects who played a Tetris-like game, a 9/29 [article](#) in *MIT Technology Review* reported.

The researchers believe that many brains located anywhere in the world could be connected over the Internet. Now that's mind blowing.

CALENDARS

US. Thurs: Headline & Core CPI 2.4%/2.3% y/y, Jobless Claims 207k, Treasury Budget \$62.0b, EIA Natural Gas Report, EIA Petroleum Status Report. **Fri:** Consumer Sentiment Index 99.5, Import & Export Prices 0.2%/0.3%, Evans, Bostic, Quarles. (Econoday estimates)

Global. Thurs: BOE Credit Conditions & Bank Liabilities Surveys. **Fri:** Eurozone Industrial Production 0.4%*m/m*/-0.3%*y/y*, Germany CPI 0.4%*m/m*/2.3%*y/y*, China Direct Investment. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators ([link](#)): Our Bull/Bear Ratio (BBR) slipped to 3.04 this week, after

climbing eight of the prior nine weeks from 2.90 to 3.32—which was its highest reading since mid-March. Bullish sentiment fell to 56.3% after rising 7.3ppts (to 61.8% from 54.5%) the prior nine weeks, while the correction count increased to 25.2% after falling -7.1ppts (19.6 from 26.7) the previous nine weeks. A week ago, 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 down to 18.5% this week; it has fluctuated in a narrow band between 17.6% and 18.8% since early June. The AAI Ratio advanced for the third week to 64.5% last week after sliding from 64.0% to 49.4% the prior two weeks. Bullish sentiment rose for the second week to 45.7% last week after falling the prior three weeks from 43.5% to 32.0%, while bearish sentiment fell for the third week to 25.1%, 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 5.7% and forward earnings growth of 11.7%, down w/w from 5.8% and 12.5%, respectively. 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 a 10-month low now 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 forecast remained steady w/w at 8.4% for 2018 and rose 0.2ppt to 5.4% for 2019. Looking at annual earnings growth, the forecasts were steady w/w at 23.0% for 2018 and 10.3% for 2019. The forward profit margin zigged back up 0.1ppt to a record high of 12.4%, which is up from 11.1% prior to the passage of the TCJA in December and compares to a 24-month low of 10.4% in March 2016. The S&P 500 ex-Financials forward growth forecasts edged down 0.1ppt to 5.9% for revenues and dropped 0.6ppt to 11.6% for earnings. The S&P 500 ex-Financials forward profit margin remained steady at 11.4%, which compares to its record high of 11.5% in mid-September and is up from 10.4% before the TCJA. Valuations 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 edged up to 2.09 from 2.08, 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 and forward earnings rose for all but Real Estate. 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 1.28 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 for 4/11 sectors and fell 0.1ppt for Real Estate. Energy's forward margin rose 0.3ppt to a four-year high, followed by 0.1ppt gains to record highs for Financials, Tech, and Utilities. Here's how the sectors rank based on their current forward profit margin forecasts: Information Technology (22.9%), Financials (19.0), Real Estate (16.0), Communication Services (15.4), Utilities (12.8), S&P 500 (12.4), Materials (11.2), Health Care (10.6), Industrials (10.2), Consumer Discretionary (7.4), Consumer Staples (7.5), and Energy (7.9).

GLOBAL ECONOMIC INDICATORS

UK GDP ([link](#)): Economic growth in the UK was flat in August, though the quarterly picture is brighter. While real GDP showed no growth during the month of August, on a rolling three-month basis—from June to August—it increased 0.7%, matching May to July's 17-month high. The head of GDP at the ONS said: "The economy continued to rebound strongly after a weak spring, with retail, food and drink production, and housebuilding all performing particularly well during the hot summer months." Looking at the four industry groupings, on a rolling three-month basis, services (to 0.5% from 0.7%)—which accounts for 80% of the UK economy—grew close to July's 18-month high in August. Meanwhile, the production group (0.7 from -0.3), which includes manufacturing, expanded for the first time in five months at its fastest pace this year—led by manufacturing's seven-month high of 0.8%. The construction sector (2.9 from 3.1) continued to grow at a robust pace after falling from February through May; growth in the agriculture sector (-0.2 from 0.1) continued to hover around zero.

UK Industrial Production ([link](#)): Industrial output rose in August for the third month to its highest level since October 2008. Headline production expanded 0.2% in August, and 1.7% during the three months through August, after contracting -1.5% the prior three months. Meanwhile, manufacturing production slipped -0.2% in August after showing no growth in July; it had rebounded 1.3% the previous two months. Looking at the main industrial groupings, intermediate goods production rebounded 1.9% during the four months ending August, following a five-month slide of -3.6%, while capital goods output dipped -0.1% in August after a three-month advance of 0.9%. Consumer goods production show nondurable goods fell -1.9% during the two months through August after expanding 3.3% the first half of this year, while durable goods output remains volatile around its cyclical high, falling -0.8% in August after a 1.2% gain and a -1.3% loss the previous two weeks. There was promising news for the UK in September's IHS Markit report—showing a modest improvement in its M-PMI (to 53.8 from 53.0) as rates of expansion in output and new orders gained traction, while the trend in new export business saw a modest recovery following August's considerable contraction.

France Industrial Production ([link](#)): Output expanded for the third month in August after posting only one increase the first five months of 2018. Headline production, which excludes construction, expanded 0.3% in August and 1.7% during the three months through August; it had contracted -1.7% during the five months through May; over the same periods, manufacturing rose 1.8% and fell -1.4%, respectively. Looking at the main industrial groupings, capital and consumer durable goods output boosted overall production during the three months through August, jumping 4.3% and 3.0%, respectively; consumer nondurable (0.7%) and intermediate (0.3) goods production showed little growth. September's IHS Markit M-PMI (52.5 from 53.5) showed manufacturing activity eased last month; slower rates of output and new business growth the main factors weighing on the PMI, with the former the weakest in two years and the latter the slowest since June.

Italy Industrial Production ([link](#)): Output in Italy rebounded in August, posting its biggest gain this year, though overall, it has been disappointing since the 3.2% surge during the final three months of last year—to its highest level since August 2011. Production, excluding construction, jumped 1.7% in August, more than reversing July's -1.6% decline; so far this year, output has increased four times and decreased four times—falling -1.5% ytd. All the main industry groupings have been very volatile this year, with only capital goods (1.9% ytd) production showing a ytd gain; production of consumer durable goods (-4.7) has contracted the most ytd, followed by intermediate (-3.7) and consumer nondurable (-2.0) goods output. Looking ahead, IHS Markit's M-PMI for Italy fell to 50.0—marking the first time in just over two years that the sector has failed to expand.

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