



MORNING BRIEFING

October 25, 2018

'Something Has To Give'

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

(1) Awful close. (2) Ugly technical picture. (3) Not too late to sell, or buying opportunity? (4) The accelerator and the brakes analogy. (5) Analysts remain bullish on S&P 500 revenues! (6) Earnings outlook remains upbeat according to analysts. (7) Investors seeing more trick than treat in earnings outlook. (8) Forward P/Es fall to fair value around 15 for S&P 500/400/600. (9) Uncivil war. (10) Cyclical lead the way down on prices and up on analysts' earnings expectations. (11) Back to the future.

Strategy I: What's the Problem? The S&P 500 is one of the components of the Index of Leading Economic Indicators (LEI). The LEI rose to a record high during September. The S&P 500 did the same on September 20, but is down 9.4% since then through yesterday's awful close ([Fig. 1](#)). The downdraft is not officially a correction yet, but it is almost there.

The technical picture has turned increasingly bearish this month. The S&P 500 is slightly below its 200-day moving average (dma), as are all of its cyclical sectors ([Fig. 2](#) and [Fig. 3](#)). The percentage of S&P 500 companies trading above their 200-dmas was down to 37% after yesterday's debacle from 44% last Friday ([Fig. 4](#)). The ratio of the equal-weighted to the market-cap-weighted S&P 500 price indexes is the lowest since October 2012 ([Fig. 5](#)).

Wait a minute! Since the start of the current bull market, such negative technicals have marked buying opportunities. If this is still a bull market, as we believe it is, then the latest bearish technicals and October's swoon should mark the latest buying opportunity.

The fundamentals still look good to us. They also look good to industry analysts, who certainly haven't gotten the "recession memo" yet; they haven't received the "global slowdown memo" either—as neither memo has been issued! Admittedly they (along with almost all economists) tend to be among the last ones to see a recession coming. However, the analysts are actually raising their S&P 500 revenues estimates for 2018, 2019, and 2020 ([Fig. 6](#)). As a result, S&P 500 forward revenues rose to yet another record high during the 10/18 week, and remains on a steep uptrend. That was just before the start of the Q3 earnings season, which so far is showing mostly solid revenues reports.

S&P 500 forward earnings also rose to yet another record high during the 10/18 week ([Fig. 7](#)). However, the upward slopes of analysts' consensus earnings expectations for 2018, 2019, and 2020 are flattening, reflecting expectations that profit margins may be getting squeezed, as already mentioned in several of the Q3 earnings calls. Nevertheless, analysts are currently predicting that S&P 500 earnings will grow 22.6% this year, 10.3% next year, and 9.5% in 2020 to \$195 per share.

Investors aren't buying what the sell-side analysts are selling. On Wednesday, the forward P/Es of the S&P 500/400/600 were down to 15.2, 14.4, and 15.0 ([Fig. 8](#)). They seem to be fretting that the Fed will make a mistake and push interest rates up to levels that will cause a recession in 2019. They may also be worrying that profit margins will get squeezed by rising labor and materials cost. They have

concerns about the outlook for overseas economies, particularly emerging market economies.

We aren't as worried about these issues. We aren't even sure that the market is down so hard during October because of them. However, one loyal follower of our research suggested that perhaps the market is spooked about the mixed-up mix of US fiscal, monetary, trade, and foreign policies. I've recently been describing them as akin to driving a car with one foot pushing hard on the accelerator while the other is tapping on the brakes.

Trump is making a big bet that his supply-side policies will boost growth while keeping inflation down. He believes that these policies will partly offset the widening federal deficit resulting from those very same policies. Meanwhile, the Fed is tapping on the brakes, which is why Trump is blasting Fed Chairman Jerome Powell so publicly. All of these developments have boosted the dollar, which is keeping a lid on inflation at home while depressing emerging markets. Also depressing global growth is Trump's trade war, especially against China. So is the surge in oil prices this year, which is mostly attributable to Trump's sanctions on Iran.

Put it all together, and the conclusion is: "Something has to give," according to our friend. At the beginning of the month, bond prices cracked, pushing yields higher. They stopped doing so when the stock market cracked on fears of higher bond yields as a result of more restrictive monetary policy. What's next? We expect that inflation data will confirm that inflation remains subdued, which might convince Fed officials to give supply-side forces a chance to work. Of course, one possible worst-case scenario is that the Fed persists in fighting these forces. That would be unfortunate.

We can't dismiss the possibility that yesterday's rout was also attributable to the pipe bombs that were sent to leaders of the Democratic Party. In the past, gridlock has been mostly bullish for stocks. The nation's Founders devised a system of political checks and balances to avert extremism. However, the country has been experiencing an increasingly uncivil war between liberals and conservatives that has been marked by only a few acts of violence so far. That trend is heading in the wrong direction, and may be starting to unnerve investors, who may be worrying that no matter who wins the mid-term elections, the uncivil war will get worse.

Strategy II: Remember Earnings. The market has been hit with a deluge of bad news. The US trade war with China looks like it will remain in the headlines as both sides dig into their positions. The 10-year Treasury yield rose above 3.00% as Fed officials pursued their gradual normalization of monetary policy while chattering about turning restrictive ([Fig. 9](#)). And record-high profit margins may get squeezed a bit by higher wages and energy costs ([Fig. 10](#)).

The current selloff has been broad-based. Since the S&P 500 peaked on September 20, almost every sector has been taken out to the woodshed, leaving only the S&P 500 Utilities sector in positive territory. Here's how the S&P 500 sectors have performed from the market's peak through yesterday's close: Utilities (4.4%), Consumer Staples (-0.5), Real Estate (-4.0), Communication Services (-7.0), Health Care (-7.3), S&P 500 (-9.4), Tech (-10.4), Energy (-11.1), Consumer Discretionary (-11.9), Financials (-12.7), Industrials (-12.9), and Materials (-17.1).

But now that fears about these items are gripping the market, it may be time to focus once again on earnings that remain remarkably strong. S&P 500 constituents' earnings are expected to grow by 22.4% y/y in Q3, according to data from Refinitiv. While that's down from the 23.4% analysts were forecasting for Q3 on July 1, it's still awfully impressive. Likewise, Q4 earnings are forecast by industry analysts to grow 19.5% y/y. Next year's y/y comparisons will be back in single digits during H1, but still showing good growth. The Q1-2019 earnings growth estimate, at 8.0%, is actually up from 7.2%, where it stood on July 1, and the Q2-2019 earnings growth consensus has been trimmed to 9.0% from 10.6%

on July 1.

Investors can continue to hide out in the Consumer Staples and Utilities sectors, but analysts aren't expecting strong earnings from either. The S&P 500 Consumer Staples sector is forecast to grow earnings by 8.9% in Q3 and 4.6% in Q4, while the Utilities sector is expected to grow earnings by 5.7% and -4.5% over the same periods.

Meanwhile, many of the other S&P 500 sectors are expected to grow their earnings much faster during Q4. Here's how all the sectors' earnings growth forecasts stack up in the year's last quarter: Energy (87.6%), Industrials (27.9), Financials (27.1), Communication Services (19.8), S&P 500 (19.5), Consumer Discretionary (16.7), Technology (13.8), Health Care (12.9), Materials (12.4), Real Estate (9.4), Consumer Staples (4.6), and Utilities (-4.5).

Here is the same comparison for all of 2019: Energy (30.3%), Industrials (11.6), Consumer Discretionary (11.3), Communication Services (11.0), Financials (9.6), Technology (8.2), Health Care (8.2), Materials (6.4), Real Estate (6.1), Consumer Staples (5.9), and Utilities (5.5).

So when reading headlines filled with dire news about tariffs, the Fed, and wage pressures, remember that—so far, anyway—earnings are still expected to be strong.

Strategy III: A Look Back & Forward. Each week, we try to bring you news that's a bit off the beaten path but may be of major importance in the future. It's often tech-related and veering toward geeky, but hopefully you find it as interesting as we do. Here's a quick update of some of the themes we've touched upon, including quantum computing, artificial intelligence (AI), and new clean fuel rules:

(1) *Ford learns quantum.* In the 7/11 [Morning Briefing](#), we dove into the world of quantum computers, those that use quantum physics to become far, far more powerful than today's computers. Google, IBM, Microsoft, and Uncle Sam along with some smaller players are in a race to develop quantum computers in the US. They face competition from around the globe, as the Chinese and others also hope to be the first to harness quantum computing.

Quantum computers can compute many problems at the same time. Governments are in the game because it's believed these computers will be able to break the cryptography that keeps all our information private. But it's hoped that quantum computers will be able to develop new molecules, advance AI, develop profitable investment portfolios, and map out the optimal way to get from Point A to Point B.

That last point seems to have caught the attention of Ford Motor, which recently hired a quantum physicist and signed a one-year contract to work with NASA's Quantum Artificial Intelligence Laboratory, the 10/22 [WSJ reported](#). "Our mission is to be early enough in the game so that when it's evolved to the point of maturity and applications that matter to the business, we'll have an advantage," Ken Washington, Ford's chief technology officer and vice president of research and advanced engineering, told the *WSJ*.

"Ford in one scenario is experimenting with how quantum computing could quickly optimize routes for multiple delivery vehicles making stops at many locations, with the goal of efficiently managing their diesel energy consumption. Quantum computing could also be useful for discovering new materials that could improve the structure of batteries for electric vehicles," the article stated.

As it turns out, Volkswagen is working on quantum computing too. The auto company and Google are in a partnership that's investigating how quantum computing can be used in areas like self-driving cars,

batteries for electric vehicles, and supply-chain management.

(2) *AI's blackeye*. In the 8/2 [Morning Briefing](#), we examined the dark side of AI, how AI-empowered robots could make serious—and in the context of war, potentially lethal—mistakes because they are too literal. We highlighted Zeynep Tufekci, a techno-sociologist and a Fellow at the Berkman Center for Internet and Society at Harvard University. She warned that people are abdicating their decision-making responsibilities, offloading them to AI-empowered computers without understanding the algorithms driving AI. She noted that AI is sometimes behind important decisions like who should be hired and who should get parole.

Amazon learned the downside of using AI in hiring. A 10/9 Reuters [article](#) revealed that Amazon's AI-empowered recruiting program was biased against women. The program was developed in 2014 to review resumes and gave applicants scores ranging from one to five stars.

The system was trained to observe patterns in resumes submitted over the prior 10 years. Most came from men, so the computer penalized resumes that included the word “women’s.” Accordingly, resumes that mentioned belonging to a women’s chess club or graduating from an all-women’s college were docked. Amazon identified the problem in 2015 and fixed it, but couldn’t guarantee that the machines “would not devise other ways of sorting candidates that could prove discriminatory.” In early 2017, Amazon pulled the plug on the program.

Gary Smith, an economics professor at Pomona College, has used the Amazon experience to buttress his case that while computers can identify patterns, they still can’t assess those patterns’ meaning or tell whether the patterns have meaning at all. That’s because they lack humans’ general intelligence and wisdom. Human reasoning is fundamentally different than AI, the author of *The AI Delusion* notes.

Smith sees reason for societal concern in organizations’ blind reliance on AI: “The combination of AI with digital advertising and highly personal data broadens the scope of the potential damage. ... The avalanche of personal data collected by business and government is being used to push and prod us to buy things we don’t need, visit places we don’t enjoy, and vote for candidates we shouldn’t trust,” he wrote in a 10/12 *Fast Company* [article](#).

His advice: Beware companies hyping AI products, and have a little faith in humanity.

Apple CEO Tim Cook also sounded the alarm about data privacy and AI in his [keynote address](#) at a privacy conference in Brussels yesterday. According to CNBC, he said: “Every day, billions of dollars change hands, and countless decisions are made, on the basis of our likes and dislikes, our friends and families, our relationships and conversations. ... These scraps of data, each one harmless enough on its own, are carefully assembled, synthesized, traded, and sold. ... Your profile is then run through algorithms that can serve up increasingly extreme content, pounding our harmless preferences into hardened convictions. ... We shouldn’t sugarcoat the consequences. This is surveillance. And these stockpiles of personal data serve only to enrich the companies that collect them. ... At its core, [artificial intelligence] promises to learn from people individually to benefit us all. Yet advancing AI by collecting huge personal profiles is laziness, not efficiency. For artificial intelligence to be truly smart, it must respect human values, including privacy. If we get this wrong, the dangers are profound. We can achieve both great artificial intelligence and great privacy standards.”

As a result, Cook recommends establishing federal privacy laws based on the right to have personal data minimized, the right to knowledge, the right to access, and the right to security.

(3) *Shippers cleaning up*. We addressed the new fuel regulation for which the shipping industry is

preparing in the 7/26 [Morning Briefing](#). The International Maritime Organization (IMO) introduced a rule in 2016 that requires ocean vessels to use fuel with sulfur content of less than 0.5% m/m (mass by mass) starting January 1, 2020, far below the current 3.5% limit.

We noted that shippers have two options, both expensive: They can either buy low-sulfur fuel or install scrubbers on the ships to clean the exhaust before it's expelled. Industry executives have estimated the move to cleaner fuel will cost shipping companies \$15 billion a year, which they're expected to pass on to their customers.

Earlier this month, the Trump administration asked the IMO to phase in the rules in the name of "experience building," a White House spokesman said in a 10/18 *WSJ* [article](#). The administration believes the move is necessary to "mitigate the impact of precipitous fuel-cost increases on consumers" and the global economy.

Greece, home to a number of shipping companies, and flag states Panama, Liberia, and the Marshall Islands have also been skeptical that there will be enough clean fuel available for the ships. They appear to be allying themselves with the US, and the Union of Greek Shipowners would like the adjustment period to extend from one to three years, noted a 10/22 *WSJ* [article](#). At this point, however, the IMO is only considering extending the rule's implementation to March 2020 and examining the safety and availability of cleaner new fuels.

The airline industry is also paying attention to whether the new rule sets sail. "Delta Air Lines Inc. finance chief Paul Jacobson said earlier this month that rising crude prices and the fuel switch for oceangoing vessels represented a "net 'bad' for the airlines," adding that Delta's in-house refinery should help offset the negative impact," noted a 10/22 *WSJ* [article](#). It included an estimate that large airlines' per-share earnings could fall by 2%-4% in 2020 due to higher fuel costs, according to Raymond James analysts.

CALENDARS

US. Thurs: Durable Goods Orders Total, Ex Transportation, and Core Capital Goods - 1.5%/0.4%/0.5%, Advance Merchandise Trade Balance -\$74.7b, Kansas City Fed Manufacturing Index, Jobless Claims 212k, Pending Home Sales 0.0%, EIA Natural Gas Report, Clarida, Mester. **Fri:** C-PMI, M-PMI, and NM-PMI Flash Estimates 54.1/55.5/54.0, New Home Sales 625k, FHFA Home Price Index 0.3%, MBA Mortgage Applications, EIA Petroleum Status Report, Beige Book, Bostic, Mester, Bullard. (Econoday estimates)

Global. Thurs: Germany Ifo Business Climate, Current Assessment, and Expectations Indexes, ECB Rate Decision 0.00%, ECB Marginal Lending Facility & Deposit Facility Rates 0.25%/-0.4%. **Fri:** Eurozone C-PMI, M-PMI, and NM-PMI Flash Estimates 53.9/53.0/54.5, Germany C-PMI, M-PMI, NM-PMI Flash Estimates 54.8/53.4/55.5, France C-PMI, M-PMI, and NM-PI Flash Estimates 53.9/52.4/54.7, BOC Rate Decision 1.75%. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators ([link](#)): Our Bull/Bear Ratio (BBR) fell for the third week this week to 2.66, slipping further below 3.00. It had climbed eight of the prior nine weeks from 2.90 to 3.32—which was its highest reading since mid-March. Movement continues to be centered in the bullish and corrections camps, with the former falling to a 16-week low and the latter rising to a 16-week high this week. Bullish sentiment sank -11.3ppts (to 50.5% from 61.8%) the past three weeks, after rising 7.3ppts (from 54.5%) the prior nine weeks, while the correction count increased 10.9ppts (30.5 from

19.6) over the three-week period, after falling -7.1ppts (from 26.7) the previous nine weeks. Four weeks 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 relatively subdued, rising from 18.3% to 19.0%, though moved above the narrow band of 17.6% to 18.8% it had fluctuated within since early June. The AAI Ratio increased to 49.2% last week after dropping from 64.5% to 46.2% the previous week. Bullish sentiment rose from 30.6% to 33.9%, while bearish sentiment edged down from 35.5% to 35.0%.

S&P 500 Earnings, Revenues & Valuation ([link](#)): S&P 500 consensus-per-share forecasts for forward revenues and earnings edged down w/w from their record highs in the prior 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 11.7%, down w/w from 5.9% and 11.8%, 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 Tax Cuts and Jobs Act (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 5.5% for 2019. Looking at annual earnings growth, the forecasts rose 0.2ppt w/w to 23.1% for 2018 and edged down 0.1ppt to 10.2% for 2019. The forward profit margin was steady at 12.3%, which is down 0.1ppt from a record high of 12.4% in early October. That's still 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 were steady w/w at 6.0% for revenues and 11.6% for earnings. The S&P 500 ex-Financials forward profit margin also 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 improved slightly w/w from their lowest levels since early May. The S&P 500's forward P/E edged up to 16.2 from 16.1, 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 rose to 2.00 from 1.98, which compares to late January's record high of 2.16 and early May's low of 1.95.

S&P 500 Sectors Net Earnings Revisions ([link](#)): The S&P 500's NERI was positive for an 18th straight month in October, its longest positive streak since the 26-month string ending August 2011. With revisions now reflecting the impact of "animal spirits" rather than the passage of the TCJA, NERI remained very strong despite falling to a 10-month low of 5.2% from 6.7% and from a record high of 22.1% in March. However, NERI improved m/m for just 1/11 sector and was positive for nine sectors (compared to five improving and 10 positive in September). Consumer Staples was the only sector with NERI improving m/m. Tech has the longest positive NERI streak, of 27 months, the best since August 2011 when its 28-month streak ended. Financials has the next best positive streak at 25 months, followed by Energy (12) and Industrials (11). Consumer Staples has the worst track record, with six months of negative NERI, followed by Materials (1), which turned negative m/m in October for the first time in 13 months. Nearly all sectors are down from their TCJA-boosted highs in February and March. Here are the sectors' October NERIs compared with their September readings: Telecom (21.7% in October, down from 22.4% in September), Industrials (12.3, 13.4), Health Care (10.9, 11.0), Tech (8.3, 11.8), Utilities (5.9, 6.0 [50-month high]), Financials (3.9, 6.2), Consumer Discretionary (3.8, 4.2), Energy (1.6, 2.5), Real Estate (0.1, 2.1), Materials (-3.6 [18-month low], 4.4), and Consumer Staples (-10.6, -12.7).

S&P 500 Q3 Earnings Season Monitor ([link](#)): With 28% of S&P 500 companies finished reporting earnings and revenues for Q3-2018, the y/y revenue and earnings growth metrics remain very strong compared to Q2's stellar results, but companies are recording a smaller revenue and earnings surprise beat. We're not seeing signs of a sharp slowdown. Of the 140 companies in the S&P 500 that have reported through mid-day Wednesday, 82% exceeded industry analysts' earnings estimates by an

average of 4.1%; they have averaged a y/y earnings gain of 25.3%. On the revenue side, 63% of companies beat their Q3 sales estimates so far, with results coming in 0.6% above forecast and 8.3% higher than a year earlier. At the same point during the Q2-2018 reporting period, a higher percentage of companies (86%) in the S&P 500 had beaten consensus earnings estimates by a higher 5.8%, and earnings were up a slightly higher 25.8% y/y. With respect to revenues, a sharply higher 76% had exceeded revenue forecasts at this point in the Q2 season by a higher 1.0%, and sales rose a slightly higher 8.9% y/y. Q3 earnings results are higher y/y for 94% of companies, vs 93% at the same point in Q2, and Q3 revenues are higher y/y for 84% vs a greater 88% a quarter ago. These figures will begin to change markedly as more Q3-2018 results are reported throughout the coming weeks. The early results on revenues are very encouraging, particularly the percentage of companies growing revenues y/y. Q3-2018 should mark the ninth straight quarter of positive y/y earnings growth and among the highest growth quarters since Q4-2010; y/y revenue growth should be positive for a tenth straight quarter, with its pace slowing somewhat but remaining well above the historical trend. The strong results are mostly due to lower tax rates and improved business conditions, but cost pressures and global growth concerns are increasing.

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