MORNING BRIEFING
October 30, 2018

Lowering Our Targets

See the collection of the individual charts linked below.

(1) Powell did say what he reportedly said on Oct. 3. (2) It was a big mistake, since he contradicted 9/26 FOMC statement and suggested Fed had a ways to go in raising rates. (3) Powell gets the most blame for having triggered October stock market rout, in our book. (4) Year-over-year comps for real GDP, revenues, and earnings will be lower in 2019. (5) Good earnings, bad guidance. (6) Analysts' optimistic outlook for earnings doesn't add up given likely slower growth of revenues and prospect of flat profits margin. (7) Lowering our outlook for earnings growth for the next two years. (8) Now shooting for S&P 500 at 2900 by year-end, 3100 next year, and 3500 in 2020. (9) Escalating trade war with China worsening the correction.

The Fed: Mystery Solved. Yesterday I noted that neither the video nor the transcript of Judy Woodruff's 10/3 interview of Jerome Powell included some comments that were widely attributed to him by the financial press and may have contributed to the October rout in stocks. A reporter sent me the full transcript, which had been chopped by PBS—along with the video—to fill 13 minutes. A video of the entire session is available here.

Powell did in fact say (at minute 11:17 on the video): "So interest rates are still accommodative but we're gradually moving to a place where they will be neutral, not that they'll be a restraint on the economy. We may go past neutral but we're a long way from neutral at this point, probably."

He said that only a few days after the 9/26 FOMC statement removed the following sentence that had appeared as boilerplate: "The stance of monetary policy remains accommodative." This sentence had been in every FOMC statement since December 16, 2015, when the Fed started its latest rate-hiking program. Some interpreted its removal to mean that the Fed is setting up for more aggressive rate increases. On the contrary, in his 9/26 press conference, Powell reassuringly said that the language simply had outlived its "useful life," suggesting that the Fed will continue its gradual rate increases toward a neutral stance, which wasn't a long way off. He contradicted that assessment on October 3, helping to set the stage for October's stock market meltdown.

Strategy: Tougher Comps in 2019. It may not be too hard for the S&P 500 to beat its depressing 2018-to-date performance during 2019. However, topping the 2018 growth rates in US real GDP, as well as S&P 500 revenues and earnings, next year would be next to impossible. That's because this year's growth was boosted by the tax cuts passed at the end of 2017 and the jump in government spending early this year.

During the current earnings seasons, both revenues and earnings results have mostly surprised to the upside. The problem is that the good news came with bad news, as companies increasingly warned that the outlook is likely to be more challenging for their businesses. In addition to tougher y/y comparisons for both revenues and earnings next year, there are mounting signs that the global economy is slowing. Consider the following:

(1) *Real GDP.* Yesterday morning, the *WSJ* "Real Time Economics" daily email reported: "Few believe a recession is near, and the expansion is widely expected to become the longest on record next year, Jon Hilsenrath and Harriet Torry write. But two big drivers of growth this year—consumers and government spending—will likely slow in the months ahead: Consumers because the impetus from income-tax cuts will diminish and government when a deal to boost spending runs out next September. Finally, the White House projection of sustained 3% growth hinges on a business-investment boom. It looked like that was happening early in the year but has faded since, suggesting corporate tax cuts may not have the long-lasting impact that was intended."

The actual article cited observes: "However, private analysts and the Federal Reserve say a slowdown is looming. Economists surveyed by the *WSJ* estimate the growth rate will slow to 2.5% by the first quarter of next year and 2.3% by the third quarter of 2019. The Fed is expecting growth to slow further to a 1.8% rate by 2021." The article starts with the following question: "What if that was as good as it gets?" Someone should convince Fed officials that it may be time to stop tapping on the brakes for a while.

(2) *Q3 S&P 500 revenues and earnings.* We will soon have the final results for the Q3 earnings season. Joe continues to track company results. While there have been some notable disappoints, the actual results have been mostly quite good. It's been some managements' cautious guidance that has unnerved stock investors. Since the end of last month through the 10/25 week, the Q3 blend of actual and estimated results rose 1.3%, while the estimate for the coming Q4 declined 0.6% (*Fig. 1*).

(3) *S&P 500 forward revenues.* S&P 500 forward revenues rose to yet another record high during the 10/18 week, raising some doubts in our minds about the widely heralded unfolding global economic slowdown (*Fig. 2*). This series is highly correlated with the actual quarterly revenues reported by the S&P 500 (*Fig. 3*). Then again, analysts are expecting a slowdown in revenues growth from 8.5% this year to 5.5% in 2019 and 4.1% in 2020 (*Fig. 4*). That makes sense since this year's revenues growth has been well above the more normal pace of 4% during global economic expansions (*Fig. 5*).

(4) *S&P 500 forward earnings.* S&P 500 forward earnings rose to another record high during the 10/25 week (*Fig. 6*). However, the 2018, 2019, and 2020 consensus earnings estimates have flattened out at record highs in recent weeks. Industry analysts are currently expecting that earnings growth will slow from 23.1% this year to 10.2% and 10.4% in 2019 and 2020 (*Fig. 7*).

(5) *Our revised estimates for earnings.* The analysts' estimates for 2019 and 2020 are probably much too optimistic. If revenues growth normalizes to 4.0%, then their forecasts imply that the S&P 500 profit margin will continue to rise to record highs (*Fig. 8*). That margin did rise to a record high of 10.9% at the end of 2017 before the cut in the corporate tax rate. It rose to yet more record highs during Q1 (11.9%) and Q2 (12.3%) this year thanks to the tax cut.

However, it's very unlikely that the profit margin will continue rising given that labor and materials costs are starting to cut into margins, according to several of the Q3 earnings season conference calls. Pushing margins higher would require a remarkable surge in productivity. Debbie and I expect that productivity growth will make a comeback over the next two years, but just enough to keep the profit margin from falling. So Joe and I are assuming it will stay flat.

If so, then the growth of S&P 500 earnings per share will be determined by revenues growth and net share buybacks. Therefore, we are lowering our estimates for 2019 and 2020 earnings growth from 6.8% and 8.8% to 4.9% and 5.3%, respectively. We now project that earnings per share will be $170 in 2019 and $179 in 2020 (*Fig. 9*). (See Table 1 in our *YRI S&P 500 Earnings Forecast*.)

Industry analysts are currently projecting $178.30 and $195.37 per share for the next two years. They may be inhaling second-hand smoke from the pot stocks.

(6) *Curbing our enthusiasm.* We believe that despite October's awful performance, the bull is still alive. However, given the downward revisions in our earnings growth estimates, we are lowering our S&P 500 price index targets. The S&P 500 got close to our year-end target of 3100 on September 20, when it rose to a record high of 2930.75. But getting all the way to 3100 by the end of the year from recent levels around 2600 may be a stretch. Now we are aiming for a retest of the record high around 2900 by the end of this year, 3100 for next year, and 3500 for 2020.

Admittedly, the bears are right that the collective monetary accommodation provided by the major central banks is diminishing. The aggregate assets of the Fed, ECB, and BOJ (priced in dollars) are looking toppy (*Fig. 10*).

Our Boom-Bust Barometer (BBB), which historically has been highly correlated with the S&P 500, has been flat at a record high all year (*Fig. 11*). The BBB is the ratio of the CRB raw industrials index and initial unemployment claims. The former has been weakening all year, while the latter probably can't fall much lower (*Fig. 12*). The weakness in the CRB index reflects the slowdown in global economic growth.

Offsetting these headwinds should be rising revenues and earnings, albeit at mid-single-digit rates. The main risk, as we saw in yesterday's market action, is an escalating trade war with China. Big gains in stock prices during the start of the day turned into losses by the afternoon after Bloomberg News reported that the US is planning to slap tariffs on more Chinese products if upcoming talks between President Donald Trump and Chinese President Xi Jinping falter.

One of our accounts emailed me near the end of trading yesterday, "Who are the traders who can turn a market from up 300 to down 560 so quickly?" My response: "Algos, not humans."

CALENDARS

US. Tues: Consumer Confidence 136.0, S&P Corelogic Case-Shiller HPI 0.2%m/m/6.0%y/y. **Wed:** Consumer Confidence 136.0, S&P Corelogic Case-Shiller HPI 0.2%m/m/6.0%y/y. (Econoday estimates)

Global. Tues: Eurozone GDP 0.3%q/q/1.8%y/y, Eurozone Economic Confidence 110.0, Germany Unemployment Change & Unemployment Claims Rate -11k/5.1%, Germany CPI, France GDP 0.4%q/q/1.5%y/y, Italy GDP 0.2%q/q/1.0%y/y, Japan Industrial Production -0.3%m/m/-2.1%y/y, Mexico GDP 0.5%q/q/2.4%y/y. **Wed:** Eurozone Headline & Core CPI 2.2%/1.1% y/y, Eurozone Unemployment Rate 8.1%, Germany Retail Sales 0.5%m/m/1.0%y/y, UK Gfk Consumer Confidence -10, Canada GDP 0.1%m/m/2.4%y/y, Japan Consumer Confidence 43.5, Japan Housing Starts 950k, Australia CPI 0.5%q/q/1.9%y/y, China M-PMI & NM-PMI 50.6/54.9, BOJ Rate Decision. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings (*link*): Forward earnings fell for MidCap last week, for the first time since late June, but rose for LargeCap and SmallCap. LargeCap is the only index at a record high, but SmallCap was just a hair below its October 12 record high. Forward earnings activity has been relatively strong in the past 12 months: LargeCap's and MidCap's forward earnings have risen in 49 of the past 52 weeks, and SmallCap's in 45. Earnings momentum remains healthy, as the yearly change in forward earnings is up from six-year lows in early 2016 and should remain strong in 2018. In the latest week, the rate of change in LargeCap's forward earnings rose to 22.6% y/y from 22.5%. That's down from 23.2% in mid-September, which was the highest since January 2011 and compares to a six-year low of -1.8% in October 2015. MidCap's y/y change dropped to 23.5% from 24.1% a week earlier, which matches mid-September's highest level since April 2011, and compares to a six-year low of -1.3% in December 2015. SmallCap's dropped to 33.2% from 33.6% and is down from an eight-year high of 35.3% the week before, which compares to a six-year low of 0.3% in December 2015. Here are the latest consensus earnings growth rates for 2018, 2019, and 2020: LargeCap (22.7%, 10.1%, 9.5%), MidCap (21.4, 12.2, 11.1), and SmallCap (29.0, 15.3, 12.4).

S&P 500/400/600 Valuation (*link*): Forward P/E ratios fell last week to lows last seen before Trump's election. LargeCap's weekly forward P/E dropped w/w to 15.2 from 15.8, and is the lowest since February 2016 and down from 16.5 in early October. That compares to a six-month high of 16.8 in mid-September, a multi-year high of 18.6 on January 26 (highest since May 2002), and of course is well below the tech-bubble record high of 25.7 in July 1999. However, last week's level remains above the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's forward P/E tumbled to 14.4 last week from 15.0, and is now the lowest since December 2012. MidCap's P/E is down from a 15-year high of 19.2 in February 2017 and the record high of 20.6 in January 2002. MidCap's P/E has been at or below LargeCap's P/E for most of the time since August 2017—the first time that alignment has prevailed since 2009. SmallCap's P/E dropped to 15.2 last week from 15.7, and is also the lowest since December 2012. That's well below its 51-week high of 20.2 in December 2017 (which wasn't much below the 15-year high of 20.5 in December 2016, when Energy's earnings were depressed). Looking at the three indexes' daily forward price/sales (P/S) ratios, all were lower w/w to levels well below their January highs: LargeCap's P/S fell w/w to 1.90 from 1.97, which is the lowest since May 2017 and down from a record high of 2.19 on January 26; MidCap's was down to a post-election low of 1.16 from 1.20, which compares to its record high of 1.40, also on January 26; and SmallCap's fell to a post-election low of 0.91 from 0.93, which compares to its record high of 1.17 in November 2013, when Energy revenues were depressed.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): With Q3 earnings reports set to flood in this week, analysts are continuing to make adjustments to their Q4 forecasts. Last week, the S&P 500's blended Q3-2018 EPS forecast jumped 40 cents w/w to $41.08. That's up 2 cents since the end of Q2, up 8.8% ytd, and up 9.5% since the passage of the Tax Cuts and Jobs Act. The $41.08 estimate represents a forecasted pro forma earnings gain for Q3-2018 of 25.2%, up from 22.2% a week earlier and from 22.1% at the end of Q1. That's above Q2-2018's blended 24.9%, and compares to Q1-2018's 26.6% (which is the strongest since Q4-2010 and likely to mark the peak of the current earnings cycle), Q4-2017's 14.8%, Q3-2017's 8.5%, Q2-2017's 12.3%, and Q1-2017's 15.3%. The S&P 500's Q3-2018 forecasted earnings gain of 25.2% y/y would be its ninth straight gain after four declines. All 11 sectors are expected to record positive y/y earnings growth in Q3-2018, with eight at a double-digit percentage rate. That compares to all 11 positive during Q2, when nine rose at a triple- or double-percentage rate. Four sectors are expected to beat the S&P 500's blended y/y earnings gain of 25.2% during Q3, compared to four beating the S&P 500's 24.9% gain during Q2. Analysts expect Energy to report another large profit jump in Q3 relative to very low earnings a year ago, with the pace slowing from Q2. The latest forecasted blended Q3-2018 earnings growth rates vs their Q2-2018 growth rates: Energy (102.9% in Q3-2018 vs 124.0% in Q2-2018), Financials (44.4, 27.5), Materials (27.3, 40.6), Tech (25.7, 29.0), S&P 500 (25.2, 24.9), Communication Services (21.3, 18.1), Industrials (20.3, 20.2), Consumer Discretionary (17.8, 21.5), Health Care (14.0, 18.4), Consumer Staples (9.0, 13.9), Utilities (6.6, 8.7), and Real Estate (3.9, 3.3). On an ex-Energy basis, analysts expect S&P 500 earnings to rise 22.3% y/y in Q3, slightly above the 21.9% in Q2; that compares to 24.5% in Q1-2018, 12.7% in Q4-2017, and 6.1% in Q3-2017 (which was the slowest growth since ex-Energy earnings rose just 2.2% in Q2-2016). Looking ahead, the Q4 estimate has risen for 1/11 sectors since the end of Q3 and dropped for 8/11. Utilities is the best performer, with its Q4-2018 forecast rising 0.7%, ahead of Health Care (0.0%) and

Tech (0.0). Communication Services is the biggest decliner, with its Q4-2018 forecast down 3.6% since the end of Q3, followed by Energy (-1.0), Materials (-0.9), Industrials (-0.8), Financials (-0.7), Real Estate (-0.7), Consumer Discretionary (-0.6), and Consumer Staples (-0.5).

S&P 500 Q3 Earnings Season Monitor (*link*): With over 48% of S&P 500 companies finished reporting earnings and revenues for Q3-2018, the earnings surprise beat is stronger compared to the same time period in Q2, but the revenue surprise and the y/y revenue and earnings growth metrics have eased somewhat from Q2's stellar results. Of the 242 companies in the S&P 500 that have reported through mid-day Monday, 79% exceeded industry analysts' earnings estimates by an average of 6.7%; they have averaged a y/y earnings gain of 25.9%. On the revenue side, 57% of companies beat their Q3 sales estimates so far, with results coming in 0.9% above forecast and 8.9% 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 lower 5.2%, and earnings were up a slightly higher 26.7% y/y. With respect to revenues, a sharply higher 72% had exceeded revenue forecasts at this point in the Q2 season by a higher 1.1%, and sales rose a higher 10.3% y/y. Q3 earnings results are higher y/y for 86% of companies, vs 87% at the same point in Q2, and Q3 revenues are higher y/y for 83% vs a greater 86% a quarter ago. These figures will continue to change markedly as Q3-2018 results flood in this week. Q3-2018 is sure to mark the ninth straight quarter of positive y/y earnings growth and among the highest-growth quarters since Q4-2010; and y/y revenue growth will 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.

US ECONOMIC INDICATORS

Personal Income & Consumption (*link*): The latest monthly data show real consumer spending continued to expand to new record highs, posting its best quarterly performance since Q4-2014 during Q3. Real personal consumption expenditures (PCE) climbed 0.3% in September, following an upwardly revised 0.4% increase in August (double the initial 0.2% estimate) and a 0.3% gain in July. Real consumer spending accelerated 4.0% (saar) last quarter, with services consumption (3.2%, saar) the fastest since Q4-2014 and goods spending (5.8) the strongest this year. Within goods consumption, nondurable goods growth accelerated for the consecutive second quarter from 0.1% during Q1 to 5.2% (saar) last quarter—the best performance since Q1-2013—while durable goods slowed to a still-robust 6.9% (saar) from 8.6% during Q2. However, real durable goods spending ended the quarter very strong, rising 1.8% and 0.9% during September and August, respectively. Real disposable income advanced for the 15th straight month in September, up 3.5% over the period to a new record high, while real wages & salaries rose 3.2% over the same period, also to a new record high. Meanwhile, September data show headline inflation eased for the second month to 2.0% y/y from 2.4% in July, which was the highest reading since March 2012. The core rate—the Fed's preferred measure—was at its 2.0% target for the fifth month.

Regional M-PMIs (*link*): Five Fed districts have now reported on manufacturing activity for October—Philadelphia, New York, Dallas, Richmond, and Kansas City—and show factories are humming, with all but Kansas City showing impressive growth. We average the composite, orders, and employment measures as data become available. The composite index decelerated a bit to 19.1 this month from 21.4 last month—averaging 22.2 the past 14 months. Composite indexes for Dallas (to 29.4 from 28.1) and New York (21.1 from 19.0) accelerated, while Philadelphia's (22.2 from 22.9) virtually matched September's healthy pace. Meanwhile, growth in the Richmond (15 from 24) and Kansas City (8 from 13) regions slowed. The new orders gauge (17.5 from 20.3) showed slower, though still strong, growth. Orders growth in the New York (22.5 from 16.5) and Dallas (18.9 from 14.7) regions improved, while billings in the Philly (19.3 from 21.4) and Richmond (20 from 34) areas slowed, though remained at elevated levels; Kansas City (7 from 15) orders expanded at a considerably slower pace than the other regions. The employment measure (15.9 from 13.1) reveals job gains were near September's pace, as manufacturers in the Dallas (23.9 from 17.7), Philly (19.5 from 17.6), and Richmond (19 from 16) regions hired at a faster rate, and those in New York (9.0 from 13.3) hired at slower pace, this month. Jobs growth in Kansas City (8 from 1) improved from September's pace, though still lagged rates in the other five regions.

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