



MORNING BRIEFING

November 1, 2018

FANG Bite

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

(1) Aspirin sales rose last month. (2) FANG holders had the biggest headaches in October. (3) A Facebook that's hard to forget. (4) Zuckerberg admits he needs to spend more on security, less on emojis. (5) The EU puts FANGs in the Peoples' Republic of GDPR. (6) The EU wants to pick FANGs' deep pockets. (7) Aging is a drag. (8) Growth at a price. (9) How fitting: Semis crawl back from the dead on Halloween. (10) Blob material feeds on CO2.

Technology I: De-FANG-ed? Given that the S&P 500 has dropped 7.5% since the market's peak on September 20, it's fitting that the stocks of aspirin sellers would be soaring: The S&P 500 Drug Retail industry, home of the drug stores, is the top-performing industry since the market peak; it has returned 9.4% over that span, nearly as much as the S&P 500 has relinquished.

Certainly, anyone owning FANG stocks has a big headache from October's stock swoon. The FANGs' market value has fallen 11.8%, or \$281 billion, from the S&P 500 peak on September 20 through yesterday's Halloween close. Each of its constituents contributed to the pain, having fallen as follows: Facebook (-8.5%), Amazon (-17.8), Netflix (-17.4), and Alphabet (-9.3), parent of Google ([Fig. 1](#)). But even those poor performances understate the damage each of the stocks has suffered individually since they hit their respective highest levels of the year.

Facebook's stock has had the worst performance, falling 30.2% from its July 25 peak through yesterday's close thanks to the difficulties and costs involved with trying to stamp out fake news on the platform. Not far behind it are the drops in the shares of Netflix (down 28.0% since July 9), Amazon (down 21.6% since September 4), and Google (down 15.1% since July 26). Let's take a look at what has taken a bite out of these stock prices:

(1) *Policing social media.* Facebook shares have been hit hard as the massive cost of ridding fake news and hateful groups from social media becomes clear. The issue rose to national attention when it was discovered that foreign organizations had put fake news on Facebook pages to sway the electorate during the 2016 presidential election campaign. Angst about the problem only grew last spring as CEO Mark Zuckerberg's testimony before governing bodies in the US and Europe made it clear the company did not have its hands around the problem.

This week, investors received a stark reminder of just how expensive combating this problem will be. Facebook's revenues climbed 32.9% y/y in Q3, but the company's expenses grew even faster: 52.6%. And the company warned that expenses will continue to grow 40%-50% y/y in 2019. While no numbers were given, Zuckerberg did say on the company's 10/30 [conference call](#): "[T]he last few years and next year are probably going to be the biggest growth in the investment in the security efforts that we will see."

Despite the elevated expenses, Facebook's Q3 results beat Wall Street's estimates. Earnings of \$1.76

a share, up 10.7% y/y, came in above analysts' target of \$1.46. The shares rose 3.8% yesterday.

(2) *Defending privacy*. A push to improve consumer privacy on the Internet also looks like it will be costly for Internet companies like Google and Facebook. Those fears were inflamed by news in September 2017 that security at credit reporting agency Equifax was breached, compromising the personal information of millions of US Internet users.

The European Union (EU) first acted to safeguard personal data privacy by passing the General Data Protection Regulation (GDPR), which went into effect in May. The privacy law “restricts how personal data is collected and handled. ... [It] focuses on ensuring that users know, understand, and consent to the data collected about them,” according to a 3/19 [article](#) in *Wired*.

It continued: “Under GDPR, pages of fine print won’t suffice. Neither will forcing users to click yes in order to sign up. Instead, companies must be clear and concise about their collection and use of personal data like full name, home address, location data, IP address, or the identifier that tracks web and app use on smartphones. Companies have to spell out why the data is being collected and whether it will be used to create profiles of people’s actions and habits. Moreover, consumers will gain the right to access data companies store about them, the right to correct inaccurate information, and the right to limit the use of decisions made by algorithms, among others.”

The GDPR rules are far-reaching. They cover EU residents even if the data are processed outside of the EU. Google and Facebook have made changes to their policies globally because it is simpler to have one system, the *Wired* article contends. Violators face fines of up to 4% of annual global revenue or 20 million euros, whichever is higher.

The US government is getting in on the act. The US Commerce Department is “seeking comments on how to set nationwide data privacy rules” a 9/25 Reuters [article](#) reported. Also, Congress and the Trump administration have held meetings on the subject, and California has enacted privacy legislation.

(3) *The taxman cometh*. European policymakers are developing rules that would tax the revenues tech companies generate in the EU. “Calls to tax big tech have been fueled by the relatively small amounts paid in Europe by tech companies, some of which route profits to low-tax countries in the region. Tech companies fear the rules could set a precedent that would be followed by governments elsewhere,” a 10/30 CNN [article](#) reported. French President Emmanuel Macron supports a European Commission plan for a 3% tax on sales of certain online services, which could be in place by 2020.

The UK may beat the EU to the punch. UK Treasury Chief Philip Hammond said Monday the country will implement a 2% tax on the sales of digital services starting in April 2020. The tax will apply to profitable companies with global revenues of at least 500 million pounds, a 10/29 CNN Business [article](#) stated. Facebook, Google, and Amazon reportedly will be affected, and the UK expects to raise about 400 million pounds a year in tax revenue.

(4) *Law of large numbers*. The FANG giants may be entering middle age—a period of growth, but at a slower pace than they enjoyed in their youth. Facebook’s daily active users grew 1.6% q/q, down from the 4% and 5% rates enjoyed in years past. Amazon projected 10%-20% sales growth in Q4, which is fabulous for most retailers but far below the 30% growth in Q4 last year.

Netflix is perhaps the most youthful of the FANG crowd. It surprised investors by continuing its strong subscriber growth in Q3: 5.4% q/q. Google’s Q3 earnings beat expectations, but its revenues missed despite 21% y/y growth.

(5) *A game of expectations.* With FANG shares falling into bear market territory last month, it's fair to wonder whether all the bad news is priced into the stocks. FANG shares sport a forward P/E of 46.8, down from 60.0 at the start of the year ([Fig. 2](#)). The FANG average forward P/E is lifted by Netflix (76.0) and Amazon (66.0) and depressed by the 23.5 forward P/E of Google and 18.0 multiple of Facebook ([Fig. 3](#), [Fig. 4](#), [Fig. 5](#), and [Fig. 6](#)).

The FANG shares have historically traded with a forward P/E closer to 60 times, dropping below 50 briefly in 2016. But the world may have irrevocably changed for the shepherds of digital data. It's certainly possible that the harsher operating environment they now face, with new rules and taxation, will prevent P/E expansion. If we had to guess, the market still needs to adjust to the bite a revenue tax will take out of tech company profits because it wasn't discussed in Facebook's earnings conference call.

Over the past three months, analysts have trimmed Facebook's 2018 earnings-per-share estimate by three cents to \$7.11, and its 2019 estimate by 11 cents to \$8.08. Netflix earnings were trimmed over the past three months to \$2.63 a share this year, down seven cents, and \$4.13 next year, down 28 cents.

Google's 2018 earnings-per-share estimates have improved over the last three months to \$41.76, up \$1.48, but 2019 targets fell slightly to \$47.41, down from \$47.91 three months ago. And Amazon's 2018 earnings estimates have improved, jumping to \$19.66 this year, up \$2.58 from three months ago, and next year's earnings target stands at \$26.81, up from \$25.29 three months ago.

Technology II: Semis Recharging? After their terrible losses earlier in October, we were glad to see that semiconductor stocks were among the leaders in the market rally of the past two days. The S&P 500 Semiconductors stock price index and the S&P 500 Semiconductor Equipment stock price index each added 5.6%, sharply outpacing the 2.7% gain in the S&P 500.

Granted, two consecutive days of big gains do not make a trend. Those indexes are still laggards, with Semiconductors experiencing a small drop of 1.8% and Semiconductor Equipment seeing a big loss of 28.0% ytd ([Fig. 7](#) and [Fig. 8](#)). But the rally of the past two days was a nice start, especially since it wasn't prompted by good news. The latest batch of earnings was mostly disappointing, with the exception of Intel's report last week. Thanks to a surge in demand for personal computers, the company reported a 42% jump in earnings, and its Q4 guidance was above analysts' estimates, a 10/25 *WSJ* [article](#) reported.

Analysts have steadily been raising their earnings estimates for the S&P 500 Semiconductors industry over the past two years ([Fig. 9](#)). Conversely, they've been sharply cutting estimates for the S&P 500 Semiconductor Equipment industry over the past five months ([Fig. 10](#)). As a result, the Semiconductors industry now is expected to grow revenues 3.2% and earnings 1.8% next year, while the Semiconductor Equipment industry experiences declines in both, with revenues falling 3.9% and earnings down 8.9% next year ([Fig. 11](#), [Fig. 12](#), [Fig. 13](#), and [Fig. 14](#)).

Bulls can take heart in the Semiconductor Industry Association's (SIA) report that shows worldwide semiconductor sales in September grew 13.8% y/y and 2.0% m/m, according to the SIA's [press release](#). The y/y sales growth was a modest deceleration from earlier this year when growth topped 20%. However, total revenue generated has continued to climb to record highs.

Technology III: Material Made from Spinach Grows & Eats CO₂. Scientists at MIT have invented a new material that can grow when exposed to sunlight. It's a synthetic gel that uses the chloroplasts from spinach leaves to capture carbon from CO₂ in the air, according to a 10/11 *MIT News* [article](#). In

the future, the chloroplasts will be replaced by nonbiological catalysts.

“The material might, for example, be made into panels of a lightweight matrix that could be shipped to a construction site, where they would harden and solidify just from exposure to air and sunlight, thereby saving on the energy and cost of transportation,” the article explains.

The material also repairs itself when exposed to sunlight or indoor lighting. So if it was scratched or cracked, the material could grow on its own to fill in the void.

And finally, the material's ability to take carbon dioxide out of the air would benefit the environment. “Our work shows that carbon dioxide need not be purely a burden and a cost,” says Professor Michael Strano in the article. “Making a material that can access the abundant carbon all around us is a significant opportunity for materials science. In this way, our work is about making materials that are not just carbon neutral, but carbon negative.”

The article does not say how one stops this material from growing—which conjures up spooky images from the movie “[The Blob](#)” (1958) starring a young Steve McQueen.

CALENDARS

US. Thurs: Productivity & Unit Labor Costs 2.3%/1.1%, Jobless Claims 212k, Challenger Job-Cut Report, Construction Spending 0.2%, ISM & IHS M-PMIs 59.0/55.9, EIA Natural Gas Report. **Fri:** Total, Private, and Manufacturing Payroll Employment 190k/184k/15k, Unemployment Rate 3.7% Average Hourly Earnings 0.2%/m/m/3.1%/y/y, Average Workweek 34.5hrs, Merchandise Trade Balance -\$53.6b, Factory Orders 0.5%, Baker-Hughes Rig Count. (Econoday estimates)

Global. Thurs: UK M-PMI 53.0, Canada M-PMI, China Caixin M-PMI 50.0, Japan M-PMI, BOE Bank Rate & Asset Purchase Target 0.75%/£435b, BOE Inflation Report, Carney. **Fri:** Eurozone, Germany, France, and Italy M-PMIs 52.1/52.3/51.2/49.7, Canada Employment Change & Unemployment Rate 12.5k/5.9%, Australia Retail Sales 0.4%. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators ([link](#)): Our Bull/Bear Ratio (BBR) fell for the fourth week this week to 2.24—its lowest reading since early May. 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 25-week low and the latter rising to a 25-week high this week. Bullish sentiment sank -17.5ppts (to 44.3% from 61.8%) the past four weeks, after rising 7.3ppts (from 54.5%) the prior nine weeks, while the correction count increased 16.3ppts (35.9 from 19.6) over the four-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 remained relatively subdued, rising from 18.3% to 19.8% the past two weeks, though for the second week it was above the narrow band of 17.6% to 18.8% it had fluctuated within since early June. The AAI Ratio declined to 40.6% last week after increasing from 46.3% to 49.2% the prior week. Bullish sentiment fell from 33.9% to 28.0%, while bearish sentiment rose from 35.0% to 41.0%.

S&P 500 Earnings, Revenues & Valuation ([link](#)): S&P 500 consensus-per-share forecasts for forward revenues and earnings were stalled w/w and remain a tad below their record highs in early October. 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 11.6%, compared to readings a week earlier of 5.8% and 11.7%, respectively. Forward revenues growth is down from an 80-month high of 6.3% at the end of February, and 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 2018 forecast edged up 0.1ppt w/w to 8.5% and 2019's was steady at 5.5%. Looking at annual earnings growth, the 2018 forecast rose 0.1ppt w/w to 23.2% and edged down 0.1ppt to 10.1% 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 revenue growth forecast was steady w/w at 6.0%, but forward earnings growth ticked down 0.1ppt to 11.5%. 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 tumbled w/w to their lowest levels since February 2016. The S&P 500's forward P/E dropped w/w to 15.3 from 16.2, which compares to a 16-year high of 18.6 at the market's prior peak in late January and well under its more recent low of 16.0 in early May. The S&P 500 price-to-sales ratio dove to 1.89 from 2.00, which compares to late January's record high of 2.16 and is also well below the prior 2018 low of 1.95 in May.

S&P 500 Sectors Earnings, Revenues & Valuation ([link](#)): Consensus forward revenue forecasts rose w/w for five of the 11 of the S&P 500 sectors, but forward earnings rose for just three. Energy and Tech were the only sectors to have both measure improve w/w. 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 are now well below their 2018 highs 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 1.08 compares to a record high of 1.56 in May 2016, and its P/E of 13.5 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 margin was steady for 8/11 sectors and ticked down 0.1ppt for these three sectors: Communication Services, Materials, and Real Estate. Here's how the sectors rank based on their current forward profit margin forecasts: Information Technology (22.9%), Financials (19.0), Real Estate (15.8), Communication Services (15.3), Utilities (12.8), S&P 500 (12.3), Materials (11.0), Health Care (10.6), Industrials (10.2), Energy (7.9), Consumer Staples (7.5), and Consumer Discretionary (7.4).

S&P 500 Q3 Earnings Season Monitor ([link](#)): With nearly 63% 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 313 companies in the S&P 500 that have reported through mid-day Wednesday, 79% exceeded industry analysts' earnings estimates by an average of 7.0%; they have averaged a y/y earnings gain of 25.1%. On the revenue side, 59% of companies beat their Q3 sales estimates so far, with results coming in 0.9% above forecast and 8.2% higher than a year earlier. At the same point during the Q2-2018 reporting period, a higher percentage of companies (82%) in the S&P 500 had beaten consensus earnings estimates by a lower 5.3%, and earnings were up a higher 26.6% y/y. With respect to revenues, a sharply higher 73% had exceeded revenue forecasts at this point in the Q2 season by a slightly higher 1.0%, and sales rose a higher 10.0% y/y. Q3 earnings results are higher y/y for 87% of companies, vs 85% 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 as more Q3-2018 results are reported. 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. Furthermore, fewer companies are reporting positive y/y revenue growth and surprises.

US ECONOMIC INDICATORS

ADP Employment ([link](#)): In October, private industries added a larger-than-expected 227,000 to payrolls, 49,000 above the expected 178,000 gain, and the first back-to-back increases above 200,000 since the start of the year. There was a downward revision to both September (to 218,000 from 230,000) and August (to 162,000 from 168,000) payrolls, for a net loss of -18,000. According to the report, “The job market bounced back strongly last month despite being hit by back-to-back hurricanes. Testimonial to the robust employment picture is the broad-based gains in jobs across industries. The only blemish is the struggles small businesses are having filling open job positions.” Last month, employment gains in service-providing (189,000) industries accelerated for the second month, while goods-producing (38,000) slowed slightly. The latest data show both construction and manufacturing industries added 17,000 to payrolls in October, the former at just half September’s pace and the latter nearly double September’s pace; over the past two years, they’ve boosted payrolls by 423,000 and 353,000, respectively. Within service-providing industries, the increase was broad-based, with trade, transportation & utilities (61,000), leisure & hospitality (40,000), professional & business services (36,000), and health services (31,000) leading the pack. By company size, large (102,000) companies moved to the top of the leader board, accounting for 45% of October’s gain—nearly all service-providing (96,000) jobs. Medium-sized companies fell to the number two spot, adding 96,000 jobs—73,000 service-providing and 23,000 goods-producing. Small companies remained in the cellar, adding 29,000 to payrolls—its second smallest gain this year—with a mix of 21,000 service-providing and 9,000 goods-producing.

Employment Cost Index ([link](#)): Labor costs remain tame despite the tight labor market. Private-sector labor costs rose at a faster pace during Q3, though the yearly rate remained subdued. Total compensation costs accelerated 0.8% last quarter, after slowing from 1.0% to 0.6% during Q2. The quarterly pickup reflected bigger gains in wages & salaries (to 0.8% from 0.6%) last quarter, while benefits’ costs (0.4 from 0.8) rose at half Q2’s pace. Compensation costs rose 2.9% y/y—matching Q2’s rate, which was the highest in a decade. Wages & salaries accelerated 3.1% y/y—the biggest yearly gain since Q2-2008—while the rate for benefits costs eased to 2.5% y/y after accelerating fairly steadily from 1.2% during Q1-2016 to 2.8% during Q2-2018.

GLOBAL ECONOMIC INDICATORS

Eurozone CPI Flash Estimate ([link](#)): October’s CPI rate is expected to accelerate to its highest reading since the end of 2012, according to the flash estimate. October’s report estimates the rate accelerated for the second month, to 2.2% y/y last month, after easing from 2.1% in July to 2.0% in August—above the ECB’s target rate of just under 2.0% for the sixth month. Looking at the main components, energy (to 10.6% from 9.5% y/y) once again is expected to have the highest annual rate in October, posting its fastest pace since November 2011. Also expected to move higher, though modestly, are rates for services (1.5 from 1.3) and non-energy industrial goods (0.4 to 0.3). Meanwhile, the rate for food, alcohol & tobacco (2.2 from 2.6) is expected to post its slowest pace since March. The core rate—which excludes energy, food, alcohol, and tobacco—is calculated to move up to 1.1% y/y from 0.9% the prior two months, matching its high for the year posted in both July and May.

Japan Consumer Confidence ([link](#)): Consumer confidence in October fell unexpectedly to its lowest level in 21 months, though remained at a relatively high level. It fell for the sixth time this year, to 43.0, though is not far from its four-year high of 44.6 posted from November through January. Three of the four components moved lower in October: employment (to 46.8 from 47.7), income growth (41.3 from 41.9), and overall livelihood (41.4 from 41.5); willingness to buy durable goods was unchanged at 42.4. All measures remained at relatively high levels.

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