MORNING BRIEFING
November 8, 2018

'Don't Be Evil'

See the collection of the individual charts linked below.

(1) Holiday treats following October's tricks? (2) Consumers are ready to do what they do best during the holidays. (3) Consumer Optimism Index highest since 2000. (4) Consumer Discretionary sector among the leaders this year so far, and probably through year-end. (5) Tariffs will be next year's problem. (6) Google's don't-be-evil mantra falls to bottom of its code of conduct. (7) Google has disgruntled employees, and is under scrutiny by the White House and EU. (8) League of Legends shows off AR on live stage.

Consumer Discretionary: Santa's Coming. Before the Trick-or-Treaters had rung the first bell, we started seeing stores restocking their shelves with holiday items. Yes, the annual holiday shopping surge is officially underway, and this year it looks to be bountiful. Analysts are calling for a y/y sales increase north of 4% thanks to a healthy and optimistic consumer. By some estimates, holiday sales could amount to a record $1.0 trillion. But if the tariff tug of war continues between the US and China, 2019 could deliver a lump of coal to the retail industry in the new year. Consider the following:

(1) *Consumers ready, willing, and able to spend.* Consumers are a relatively predictable bunch. If they have cash, they'll spend it, and right now they're flush. The US unemployment rate has fallen to 3.7%, a 49-year low (*Fig. 1*). Real average hourly earnings for production and nonsupervisory workers has risen 0.8% y/y to a new high (*Fig. 2*).

As a result, consumer spending has been healthy. Personal consumption expenditures rose 5.0% y/y in September, a touch more than the 4.9% increase in disposable personal income (*Fig. 3*). Meanwhile, the gasoline futures price has fallen to $1.69 a gallon, down from $2.27 in late May, suggesting the price of gasoline at the pump should continue to fall from its recent peak of $2.45 per barrel (*Fig. 4*). It all adds up to a happy consumer; the October Consumer Optimism Index (which averages the Consumer Sentiment Index and the Consumer Confidence Index) is at its highest level since November 2000 (*Fig. 5*).

(2) *Happy consumer, happy forecasts*. With the US consumer employed and jolly, forecasters are calling for solid increases in holiday spending. The National Retail Federation (NRF) expects holiday retail sales in November and December to increase 4.3%-4.8% y/y. The association's estimate excludes sales of autos, gas, and restaurants, and it includes online sales.

The NRF's estimate is higher than the average annual increase of 3.9% over the past five years, but it's a touch lower than the 5.3% increase enjoyed last year.

Craig Johnson, president of Customer Growth Partners, is calling for a 5.1% jump in in-store and online spending this holiday, reported a 10/28 article in Chain Store Age. He forecasts online sales surging 9.9%, compared to the 11.4% jump last year. Industries expected to rake in higher sales this season will include health and personal care (3.8%), clubs and superstores (5.2), apparel (5.4), and consumer electronics (6.1), thanks to new products including the iPhone, the Galaxy Note 9, and Sony's audio products.

Conversely, Johnson warns that sports/toys/books sales are projected to decline almost 6.5% due to the demise of Toys R Us, and department stores sales will likely fall around 2.0% due to Sears' stores closures.

(3) *A leading sector*. A broad swath of Consumer Discretionary stocks has performed well this year despite the market's October swoon. The sector is up 9.1% ytd, near the top of the leaderboard.

Here's how the sectors stack up year-to-date through Tuesday's close: Tech (9.6%), Health Care (9.5), Consumer Discretionary (9.1), S&P 500 (3.1), Utilities (3.0), Real Estate (-1.0), Consumer Staples (-1.6), Financials (-3.8), Energy (-4.2), Industrials (-5.0), Materials (-9.2), and Communication Services (-9.5) (*Fig. 6*).

The Consumer Discretionary sector was driven higher ytd by the Department Stores industry (46.2%), Automotive Retail (27.2), Specialty Stores (19.0), General Merchandise Stores (13.6), and Hypermarkets & Super Centers (12.8) (*Fig. 7*).

Something to keep an eye on is the impact tariffs may have on the prices of the goods retailers sell. Large retailers tend to order goods and have them shipped well in advance of the holiday season. So they should evade the impact of tariffs this season, a 9/18 *WSJ* article reported.

The initial round of tariffs imposed this summer on $50 million of goods affected primarily intermediate inputs or capital equipment, with only 1% of the tariffs affecting consumer goods. However, on September 24 the latest round of tariffs affecting another $200 million of goods went into effect, and 24% of those goods were consumer goods. The 10% tariff will more than double to 25% on January 1, according to a 9/24 guide from the Peterson Institute for International Economics.

The stronger dollar will help offset any initial tariff costs. And retailers can push suppliers to absorb some of the cost increases. But if the trade war continues into 2019, retailers may not be able to escape the ramifications of the tariff tiffs for much longer.

Tech I: Google Being Evil? Since 2000, Google was known by its unofficial motto: "Don't be evil." The saying appeared at the start of the tech titan's code of conduct, which eschewed the corporate-babble of "old" companies. But this spring, the phrase moved from the first line of Google's code of conduct to the last line, a 5/18 Gizmodo article reported.

Is this a difference without a distinction? Perhaps. However, the company, which turned 20 this year, has been entangled in numerous problematic situations recently that have taken the shine off the stock. Alphabet, Google's parent, has come under fire for how it has handled employee harassment cases. President Trump is threatening to break the company into pieces. Europe wants to tax its revenues. And the company appears to be wading into a hornet's nest by putting news on its search page.

One piece of good news: Alphabet's Waymo subsidiary just received a permit for autonomous driving in San Francisco, and it's expected to launch an autonomous driving service in Phoenix by year-end.

I asked Jackie to have a closer look at Google's world. Here is her report:

(1) *Employees disgruntled*. A 10/25 *NYT* article on how Google had dealt with sexual misconduct cases involving senior employees so enraged employees that nearly 17,000 walked off the job in protest last Thursday in locations scattered around the world, an 11/2 Vox article estimated. In the most egregious

allegation, the former head of Android was given $90 million when he left in 2014 after being accused of sexual misconduct by an employee with whom he had been having an extramarital relationship.

The example was one of three where Google protected senior executives accused of sexual misconduct and paid them millions, the *NYT* claimed. In response to the story, Google noted that 48 people were fired for sexual harassment over the last two years without receiving an exit package.

Organizers of the walkout, which was sanctioned by management, also produced a list of demands. They want Google to change how it "handles sexual harassment, including ending its use of private arbitration in such cases. They also asked for the publication of a transparency report on instances of sexual harassment, further disclosures of salaries and compensation, an employee representative on the company board, and a chief diversity officer who could speak directly to the board," a 11/1 *NYT* article reported.

Management has responded to employees' calls for action in the past. Earlier this year, the company decided not to renew a Pentagon contract to use Google artificial intelligence to analyze drone videos after employees objected to using company technology in warfare.

(2) *On Trump's radar*. In an 11/4 interview with Axios on HBO, President Trump said his administration is looking at antitrust investigations of Google, Facebook, and Amazon. Technically, any case would arise out of the Federal Trade Commission and the Department of Justice.

While he raised the issue, President Trump hedged by saying: "I'm not looking to hurt these companies; I'm looking to help them. As far as antitrust is concerned, we'll have to take a look at that, but I want them to do well. I want Amazon to do well. I want Google to do well. I want Facebook—I want all of 'em to do [well]—these are great companies."

Breaking up the large tech companies is an idea that has been raised by others including Tim Berners-Lee, a founder of the Internet. He told Reuters that companies like Facebook and Google "had grown so powerful they might need to be split up unless rivals could reduce their influence," the 11/5 *FT* reported.

(3) *On the EU's radar*. While the US President threatens, the European Union (EU) is already taking action. In July, the EU hit Google with a $5 billion antitrust fine because of Android's dominant mobile operating system, a 7/18 CNBC article reported. It claims Google "forced smartphone makers to pre-install Google apps Chrome and Search in a bundle with its app store, Play. … [It also] violated competition rules by paying phone makers to exclusively pre-install Google search on their devices and preventing them from selling phones that run other modified, or 'forked' versions of Android." If the illegal conduct isn't ended, Alphabet could face additional charges of up to 5% of its average daily worldwide revenue.

Were that not enough, the EU is considering taxing Google, Facebook, and other Internet companies 3% of their revenue because they believe the companies are not paying their fair share of taxes. However, support for the proposal is mixed. France supports the proposal, while Ireland, Sweden, and Denmark are against it. Germany initially supported the bill, but now is looking to water down and delay the proposal, a 10/29 Guardian article reported. The UK and Spain are going forward with their own tax plans.

(4) *New ventures*. In a move that seems slightly tone-deaf, Google has introduced Discover, a reformatted version of its news feed. Discover articles appear under the Google search box. The company promises to deliver articles that are relevant to users. So if Google knows you're planning a

trip, it may show the best places to eat or sights to see at your destination, explained a company blog. The blog doesn't say how Google will know your interests.

The new offering reinforces the fact that Google knows an awful lot about everyone and is constantly trying to monetize that information. Perhaps not the best thing to do when there's a backlash against privacy invasion by large Internet companies.

Fortunately, the company does have some positive news. Alphabet's Waymo division is testing pricing models for rides in its autonomous vehicles in Phoenix, a recent article in Techcruch relayed. In addition, the company received permission to begin testing driverless vehicles on public roads in California, a 10/10 CNBC article stated.

Of course, this begs the question: If you take a Waymo car to an Italian restaurant, will Discover deliver articles about the tastiest pasta to eat?

(5) *The numbers*. Google and Facebook are both members of the new S&P 500 Interactive Media & Services industry, added to the revamped Communication Services sector in late September. The industry has seen its price index fall 10.8% from its peak on September 27, and trades at a forward P/E of 22.4. This new industry is expected to grow revenues at a healthy 27.9% pace in 2018 and 26.6% in 2019. Earnings are forecast to rise 25.4% in 2018, but slow substantially to 9.0% next year. The industry's profit margin is forecast to decline from an expected 23.3% in 2018 to 21.1% in 2019, whereas most industries in the S&P 500 are expected to see margins expand next year.

As for Google, its stock trades at 22.3 times expected 2019 earnings of $47.38 per share, which represents 13.3% growth over expected earnings in 2018. One item that jumped out from the company's Q3 earnings was the bounty of cash Alphabet has stashed: $106.4 billion. That can purchase an awful lot of stock.

(6) *Hedge clause.* As noted in our hedge clause, the above discussion "should not be construed as recommendations to buy, sell, or hold any security." In addition, as we've noted before, we aren't preachers: We don't make judgments on good vs evil. As investment strategists, we do bullish vs bearish. We remain bullish on the US stock market, and expect that the FANG stocks will continue to participate in the rally, though they might be laggards for a change given some of the challenges discussed above. That would be a healthy development for the stock market, in our opinion.

Tech II: AR Gets Real. Fantasy and reality just moved one step closer. The opening ceremony for the League of Legends (LOL) 2018 World Championship in South Korea combined augmented reality (AR) characters and real human singers in a performance that left you wondering just how the magic was made.

A little background for those readers who aren't 13-18 years old: LOL is the world's most popular video game. It's a multi-player online battle arena played on personal computers and was created by Riot Games, a video game company owned by Tencent. Peak viewership at this year's world championships was 205.3 million people, more than 200 million of whom were in China.

Riot introduced four new female characters who are part of a fictional K-pop band, K/DA. These characters each have names, personalities, and backgrounds laid out on the LOL website. They also have an animated hit song and video, "Pop/Stars," that has had more than 19 million views on YouTube since its released on November 3.

The fictional band's AR appearance at the LOL World Championships' opening ceremony last week has the Internet buzzing. On stage were the real humans singing the hit song. But those watching the jumbotrons or watching the event from home saw both the humans and the AR characters performing on stage together.

Riot has produced original music in the past, and it had a AR dragon flying around the stadium at last year's World Championship, reported an 11/5 article on The Verge.

By merging AR and reality, Riot's opening ceremony production this year gives us a peak into the future. The AR characters have tails and wings, making them easy to distinguish. But it might not be long before the distinction between AR and humans gets tougher to make.

CALENDARS

US. Thurs: Jobless Claims 213k, EIA Natural Gas Report, FOMC Announcement 2.125% (2.00% to 2.25%). **Fri:** Consumer Sentiment Index 98.0, PPI Headline, Core, and Core Less Trade Services 0.2%/0.2%/0.2%, Wholesale Trade Inventories 0.3%, Baker-Rig Count, Williams, Quarles. (Econoday estimates)

Global. Thurs: Germany Trade Balance €20b, China Trade Balance, China Foreign Direct Investment, Mexico CPI 0.5%m/m/4.9%y/y, ECB Published Economic Bulletin. **Fri:** UK GDP 0.1%m/m/0.6%q/q/1.5%y/y, UK Headline & Manufacturing Industrial Production 0.4%/0.3% y/y, UK Trade Balance -£3900, China CPI & PPI, Mexico Industrial Production 1.8% y/y, RBA Statement of Policy. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): Our Bull/Bear Ratio (BBR) fell for the fifth week this week to 2.15—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 30-week low and the latter rising to a 30-week high this week. Bullish sentiment sank -19.3ppts (to 42.5% from 61.8%) the past five weeks, after rising 7.3ppts (from 54.5%) the prior nine weeks, while the correction count increased 18.1ppts (37.7 from 19.6) over the five-week period, after falling -7.1ppts (from 26.7) the previous nine weeks. Meanwhile, bearish sentiment remained subdued, unchanged at 19.8% this week, though for the third week it was above the narrow band of 17.6% to 18.8% it had fluctuated within since early June. The AAII Ratio climbed to 52.4% last week after falling from 49.2% to 40.6% the prior week. Bullish sentiment rose from 28.0% to 37.9% last week, while bearish sentiment fell from 41.0% to 34.5%.

S&P 500 Earnings, Revenues & Valuation (*link*): S&P 500 consensus-per-share forecasts for forward revenues and earnings rose to record highs for the first time in three weeks. 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 10.3%, down 0.1ppt and 1.3ppts, respectively, from 5.8% and 11.6% a week ago. Forward revenues growth is down from an 80-month high of 6.3% at the end of February. Forward earnings growth is down to the lowest level since September 2016 from 16.9% in February. Prior to the passage of the Tax Cuts and Jobs Act (TCJA), forward revenue growth was 5.5% and forward earnings growth was 11.1%. Turning to the annual revenue growth expectations, the 2018 and 2019 forecasts were steady w/w at 8.5% and 5.5%, respectively. Looking at annual earnings growth, the 2018 forecast rose 0.4ppt w/w to 23.6% and dropped 0.7ppt to 9.4% for 2019. The forward profit margin rose 0.1ppt w/w back to its record high of 12.4%. That's 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 edged down 0.1ppt w/w to 5.9%, but forward earnings growth fell 1.3ppts to 10.2%. However, the S&P 500 ex-Financials forward profit margin rose 0.1ppt back to its record high of 11.5%, which is up from 10.4% before the TCJA. Valuations rose w/w from their lowest levels since February 2016. The S&P 500's forward P/E improved w/w to 15.6 from 15.3, 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 rose to 1.93 from 1.89, 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 10 of the 11 of the S&P 500 sectors, and forward earnings rose for 8/11. Materials was the only sector to have both measures fall w/w, but that was primarily due to changes in the index's composition. 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. Higher y/y margins are expected in 2019 for nine of the 11 sectors, all but Communication Services and Real Estate. During the latest week, the forward profit margin rose for 3/11 sectors and fell for two. Here's how the sectors rank based on their current forward profit margin forecasts: Information Technology (23.0%), Financials (19.1), Real Estate (15.7), Communication Services (14.9), Utilities (12.8), S&P 500 (12.4), Materials (11.6), Health Care (10.6), Industrials (10.2), Energy (8.0), Consumer Staples (7.5), and Consumer Discretionary (7.5).

S&P 500 Q3 Earnings Season Monitor (*link*): With nearly 84% of S&P 500 companies finished reporting earnings and revenues for Q3-2018, the earnings surprise beat and y/y earnings growth are stronger compared to the same time period in Q2, but the revenue surprise and y/y revenue growth metrics have eased somewhat from Q2's stellar results. Of the 418 companies in the S&P 500 that have reported through mid-day Wednesday, 78% exceeded industry analysts' earnings estimates by an average of 7.0%; they have averaged a y/y earnings gain of 28.9%. On the revenue side, 60% of companies beat their Q3 sales estimates so far, with results coming in 1.5% above forecast and 9.2% higher than a year earlier. At the same point during the Q2-2018 reporting period, a slightly higher percentage of companies (80%) in the S&P 500 had beaten consensus earnings estimates by a lower 5.2%, and earnings were up a lower 26.0% y/y. With respect to revenues, a sharply higher 72% had exceeded revenue forecasts at this point in the Q2 season by a slightly higher 1.6%, and sales rose a higher 10.3% y/y. Q3 earnings results are higher y/y for 88% of companies, vs 84% at the same point in Q2, and Q3 revenues are higher y/y for 83% vs 87% a quarter ago. While these figures will change as more Q3-2018 results are reported, it's safe to say that Q3-2018 will mark the ninth straight quarter of positive y/y earnings growth and among the highest-growth quarters since Q4-2010. Its 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 headwinds are coming in the form of increasing cost pressures and global growth concerns. One harbinger of the slowdown ahead is the fact that fewer companies have been reporting positive y/y revenue growth and surprises during the Q3 reporting season.

GLOBAL ECONOMIC INDICATORS

Eurozone Retail Sales (*link*): September retail sales remains stalled around June's record high. Sales in September were flat after a 0.3% gain in August and a -0.6% loss in July. Sales for food, drinks & tobacco climbed for the fourth time in five months, by 0.4% m/m and 1.5% over the period, while spending on automotive fuel expanded 0.4% after a two-month slide of -1.8%. Meanwhile, spending on non-food products excluding fuel fell 0.5% after a 0.6% increase and a -0.2% decrease during August and July, respectively. Over the past 12 months, retail sales rose 0.8% y/y, with spending on automotive fuel (1.1% y/y), food, drinks & tobacco (0.9), and non-food products (0.7) above a year ago, though by a small percentage. September sales are available for all of the Big Four economies, with sales in both Germany and France edging up 0.1%, the latter to a new record high. For France, it was the fourth increase in five months, for a total gain of 2.6%, while Germany's uptick followed a two-month decline of -1.4%. Meanwhile, sales in both Italy (-0.3%) and Spain (-0.6) contracted for the second time in three months, falling -0.3% and -1.0%, respectively, over the period. Among the Eurozone economies for which data are available, the largest increases in retail sales were registered in Ireland (2.9%), Latvia (1.5) and Estonia (1.4), while the biggest decreases were recorded in Portugal (-1.7) and Austria (-1.0).

Germany Industrial Production (*link*): Output unexpectedly rose for the second month in September, though barely, lacking momentum since reaching a record high in May. Germany's headline production—which includes construction—climbed 0.3% during the two months through September, after sinking -2.0% the prior two months. Excluding construction, output contracted for the third time in four months, by -0.2% in September and -2.0% over the four-month span. Construction output rebounded 2.2% in September following August's -1.5 drop; it had increased 1.1% in July. Factory production was flat in September, posting only one gain since May's record high, contracting -2.3% over the period. The main industrial groupings show only consumer nondurable goods output on a steep uptrend, with the remaining in volatile flat trends around recent highs. Germany's M-PMI for October showed growth slowing for the third month, dropping to a 29-month low of 52.2 last month. The report notes that the rise in production in October was marginal—and the weakest seen since November 2014.

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