



MORNING BRIEFING

November 13, 2018

Slowdown Ahead

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

(1) Bullish earnings and bearish guidance. (2) Nevertheless, analysts' consensus estimates for S&P 500 earnings growth are 9.4% in 2019 and 10.2% in 2020. (3) We are projecting 4.9% and 5.3% comparable growth rates. (4) Revenues growth rates are bound to slow to 4.0% trend. (5) Profit margin very unlikely to move to new record highs, as implied by analysts' revenues and earnings projections. (6) Crude oil is dropping, and back in sync with other declining commodity prices and stronger dollar. (7) Another sign of global slowdown on the demand side. (8) On the supply side, American and Canadian crude output is soaring.

Strategy: Analysts Still (Too) High on Earnings. The latest earnings season seemed to contribute to the sharp selloff in stocks during October, as some companies reported bullish earnings that were more than offset by bearish guidance about future earnings prospects. Collectively, however, the S&P 500 results through the 11/8 week were 4.9% better than analysts expected during the 9/28 week ([Fig. 1](#)). As we've noted many times before, such positive earnings hooks are par for the course. (See our [S&P 500 Earnings Squiggles Annual & Quarterly](#).)

In aggregate, the negative guidance corporate managements provided during earnings conference calls didn't deflate analysts' consensus earnings estimates for Q4-2018 and the four quarters of 2019 ([Fig. 2](#)). In fact, the 2018 estimated earnings growth rate was steady during the 11/1 week at 23.6%, the highest reading for this series ([Fig. 3](#) and [Fig. 4](#)). The 2019 estimated growth rate edged down to 9.4%. The 2020 projected growth rate remained solid at 10.2%.

In other words, the Q3 results didn't curb analysts' enthusiasm for earnings growth over the rest of this year and the coming two years. Joe and I, however, curbed our enthusiasm for the earnings outlook in the 10/30 [Morning Briefing](#). Here's more on why we did so:

(1) *Us vs them.* We lowered our estimates for earnings growth during 2019 and 2020 to 4.9% and 5.3% from 6.8% and 8.8%. We are predicting S&P 500 earnings per share will be \$162 this year, \$170 next year, and \$179 in 2020 ([Fig. 5](#)). During the 11/8 week, the comparable analysts' consensus estimates were \$162.67, \$177.69, and \$194.55.

(2) *Revenues slowdown ahead.* The growth rate of S&P 500 revenues has been remarkably strong this year, which has contributed—along with the corporate tax rate cut at the end of last year—to the strength in earnings growth. Revenues per share rose 11.2% y/y during Q2, the highest growth rate since Q2-2011 ([Fig. 6](#)).

Industry analysts are expecting a slowdown in revenues-per-share growth from 8.5% this year to 5.5% in 2019 and 4.4% in 2020 ([Fig. 7](#)). That makes sense to us, since the trend growth rate of revenues has been roughly 4.0% ([Fig. 8](#)).

In addition, the global economic outlook is deteriorating, as evidenced by the weakening trends in recent months in both the OECD Leading Indicators and the Global Composite PMI ([Fig. 9](#) and [Fig. 10](#)).

(3) *Profit margin unlikely to set new records.* What doesn't make sense to us is the implication of analysts' consensus earnings and revenues estimates that the S&P 500 operating profit margin will continue to rise to record highs. Their latest numbers imply that the profit margin will rise from 11.9% this year to 12.4% next year and 13.1% in 2020 ([Fig. 11](#)). Thomson Reuters data show that the operating profit margin rose to a record-high 10.9% at the end of 2017 before the corporate tax cut. After the cut, it rose to fresh record highs of 11.9% during Q1 and 12.3% during Q2 ([Fig. 12](#)).

During the Q3 earnings season, many company managements warned that, in addition to their revenues growth being weighed down by the global economic slowdown, their profit margins were likely to be squeezed by higher labor costs as well as the impacts of tariffs, which were raising their materials costs and disrupting their supply chains. They didn't say whether they expected to offset some of those higher costs with productivity gains.

So we don't expect the S&P 500 profit margin to rise further from here. If it remains flat in record-high territory over the next two years, then earnings growth will match revenues growth. And if that happens, then industry analysts will be lowering their heady growth rates for earnings.

Commodities: Lots of Crude. The price of crude oil is no longer diverging from other commodity prices, as it has been doing for most of this year until early October ([Fig. 13](#)). The traditional inverse correlation between the trade-weighted dollar and the price of oil was also a no-show this year until recently ([Fig. 14](#)). Now all is right with the world, as the oil price has been dropping along with the CRB raw industrials spot price index, while the dollar has remained strong.

Actually, all may not be right with the world if the 19% drop in the price of a barrel of Brent crude oil from this year's peak of \$86.29 on October 3 through Friday's price of \$70.18 is signaling a major slowing in the global economy. That's certainly part of the story. Another piece of the story is that oil prices rose this year partly as a result of crude oil output collapsing in Venezuela and President Trump withdrawing from the Iran nuke deal on May 8 and imposing renewed sanctions on Iran effective November 5 ([Fig. 15](#) and [Fig. 16](#)). However, several days before the mid-term elections, Trump handed out waivers to some of the countries that rely on Iranian crude, which triggered the recent drop in the oil price.

In any event, the Saudis and the Russians are scrambling to reduce their oil output to shore up prices. Their big problem is that American and Canadian producers are increasingly outproducing each of them. The latest available data from the US Energy Information Administration show that the US and Canada combined produced 15.2mbd during July, while Saudi Arabia and Russia produced 10.5mbd and 10.8mbd, respectively ([Fig. 17](#)). During the 11/2 week, US crude oil production soared to a record 11.7mbd, up 2.1mbd from a year ago ([Fig. 18](#)).

While lower gasoline prices should boost consumer spending, the lower oil price is likely to weigh on capital spending. Yesterday's WSJ [Real Time Economics](#) email observed:

"Consumer demand is the major driver of economic growth in the U.S. If oil prices stay relatively low, cheaper gasoline should help consumers spend elsewhere. Cheap oil also would be a check on inflation. But the energy sector is a major driver of business investment. Oil prices bottomed out in early 2016. As the industry caught up with rising prices and demand, spending soared. Since the start of 2017, investment in mining exploration, shafts and wells is up 53.2%. That blows away other business

investment categories—software is next at 16.5%, overall investment is up a moderate 9.2%. With business investment already struggling, cheaper oil could dent a key engine of economic growth.”

CALENDARS

US. Tues: NFIB Small Business Optimism Index 108.0, Treasury Budget -\$111.8b, Daly. **Wed:** Headline & Core CPI 2.5%/2.2% y/y, Atlanta Fed Business Inflation Expectations, MBA Mortgage Applications, Powell, Quarles. (Econoday estimates)

Global. Tues: Eurozone ZEW Economic Sentiment, Germany ZEW Current Situation & Expectations 65/-26, Germany CPI 0.2%^{m/m}/2.5%^{y/y}, UK Employment Change & Unemployment Rate (3-month) 25k/4.0%, Japan GDP (annualized) -0.9%^{q/q}, Australia Business & Consumer Confidence. **Wed:** Eurozone GDP 0.2%^{q/q}/1.7%^{y/y}, Eurozone Industrial Production -0.4%^{m/m}/0.3%^{y/y}, Germany GDP -0.1%^{q/q}/1.3%^{y/y}, UK Headline & Core CPI 2.5%/1.9%^{y/y}, Japan Industrial Production, China Retail Sales 9.2%^{y/y}, China Industrial Production 5.8%^{y/y}, China Fixed Assets Ex Rural (ytd) 5.5%^{y/y}. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings fell for all three of these indexes again last week. That's the first back-to-back for all three indexes since December 2015 when it fell for three straight weeks in response to tumbling oil prices. LargeCap's forward EPS dropped 10 cents w/w to \$175.28 and is now 0.1% below its record high two weeks ago. Still, that's better than the declines from the peaks for MidCap (-0.3%, last record high October 19) and SmallCap (-1.4, October 26). Forward earnings activity has been relatively strong in the past 12 months: LargeCap's and MidCap's forward earnings have risen in 47 of the past 52 weeks, and SmallCap's in 42. Earnings momentum remains healthy, as the yearly change in forward earnings is up from six-year lows in early 2016, but is looking peaky. In the latest week, the rate of change in LargeCap's forward earnings fell to 21.6%^{y/y} from 22.2%. 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 22.7% from 23.0% a week earlier, which compares to 24.1% in mid-September (the highest since April 2011) and a six-year low of -1.3% in December 2015. SmallCap's dropped to 31.2% from 32.3% and is down from an eight-year high of 35.3% in early October, 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 (23.2%, 9.0%, 9.9%), MidCap (21.6, 11.3, 10.8), and SmallCap (28.2, 13.7, 12.6).

S&P 500/400/600 Valuation ([link](#)): Forward P/E ratios improved last week for a second week from lows that were last seen before Trump's election. LargeCap's weekly forward P/E gained w/w to 15.9 from 15.5, which was up from 15.2 at the end of October in the lowest reading since February 2016. 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 rose to 15.1 last week from 15.0, which is up from 14.4 the week before that in 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 edged up to 16.1 last week from 16.0, which compares to 15.2 at the end of October in its lowest reading 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, most improved w/w but remain well below their January highs: LargeCap's P/S rose w/w to 1.98 from 1.94, which is down from

a record high of 2.19 on January 26; MidCap's increased to 1.20 from 1.19, which compares to its record high of 1.40, also on January 26; but SmallCap's dropped to 0.95 from 0.96, 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](#)): Although Q3 earnings reports are starting to tail off, analysts are continuing to make adjustments to their Q4 forecasts. Last week, the S&P 500's blended Q3-2018 EPS forecast rose \$0.36 w/w to \$42.53. That's up 3.6% since the end of Q2, up 12.7% ytd, and up 13.4% since the passage of the Tax Cuts and Jobs Act. The \$42.53 estimate represents a forecasted pro forma earnings gain for Q3-2018 of 27.8%, up from 27.1% a week earlier and from 22.1% at the end of Q1. That's now the strongest since Q4-2010 and could mark the peak of the current earnings cycle. The blended Q3-2018 growth rate compares to Q2-2018's 24.9%, Q1-2018's 26.6%, 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 27.8% 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 10 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 27.8% 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 (116.0% in Q3-2018 vs 124.0% in Q2-2018), Financials (44.7, 27.5), Materials (28.5, 40.6), Tech (28.1, 29.0), S&P 500 (27.8, 24.9), Communication Services (25.5, 18.1), Consumer Discretionary (23.4, 21.5), Industrials (19.0, 20.2), Health Care (16.4, 18.4), Utilities (11.0, 8.7), Consumer Staples (10.3, 13.9), and Real Estate (5.3, 3.3). On an ex-Energy basis, analysts expect S&P 500 earnings to rise 24.4% y/y in Q3, 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 2/11 sectors since the end of Q3 and dropped for 8/11. Materials is the best performer, with its Q4-2018 forecast rising 0.7%, ahead of Energy (0.4%) and Real Estate (0.0). Utilities is the biggest decliner, with its Q4-2018 forecast down 3.4% since the end of Q3,

S&P 500 Q3 Earnings Season Monitor ([link](#)): With 90% 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 450 companies in the S&P 500 that have reported through mid-day Monday, 77% exceeded industry analysts' earnings estimates by an average of 6.9%; they have averaged a y/y earnings gain of 28.1%. 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 26.4% y/y. With respect to revenues, a sharply higher 71% had exceeded revenue forecasts at this point in the Q2 season by a slightly higher 1.6%, and sales rose a higher 10.1% y/y. Q3 earnings results are higher y/y for 87% of companies, vs 83% at the same point in Q2, but Q3 revenues are higher y/y for only 82% vs 86% a quarter ago. We don't expect these figures to change much the remaining companies report Q3-2018 results, so 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

Global Leading Indicators ([link](#)): In September, the OECD's composite leading indicators (CLIs)—designed to anticipate turning points in economic activity relative to trend six to nine months ahead—continued to point to an easing of growth momentum in the OECD (99.5) as a whole. Easing growth momentum remains the assessment for the UK (98.9) and the Eurozone (99.6) as a whole—including France (99.4) and Italy (99.8)—while similar signs are now emerging for Germany (99.9); in August, Germany had been upgraded to stabilizing growth momentum. Looking at major non-European CLIs, stable growth momentum remains the assessment for the US (99.9) and Japan (99.7), and now is also anticipated for Canada (99.5). Among major emerging economies, India's CLI (101.3) continues to point to growth gaining momentum, while stable growth momentum remains the assessment for China's (99.3) industrial sector. Signs of easing growth momentum are surfacing in Russia (100.2)—a downgrade from August's assessment of stable growth momentum—while Brazil's CLI (102.3) continues to anticipate easing growth momentum.

Italy Industrial Production ([link](#)): Output in Italy fell in September for the fifth time this year after recording impressive growth the final half of 2017. Production, excluding construction, fell a smaller-than-expected -0.2% in September after a 1.7% increase and a -1.6% decrease the prior two months. Over the first nine months of 2018, production contracted -1.7%; it had jumped 2.9% during the final six months of last year. Looking at the main industrial groupings, September was a mixed bag, with production of consumer durable (-1.9%) and capital (-1.6) goods in the red and intermediate (1.1) and consumer nondurable (0.7) goods in the black; energy (-0.1) output was flat. Through the first nine months of this year, production of consumer durable (-6.6% ytd), intermediate (-2.1), and consumer nondurable (-1.4) goods all contracted, while capital (-0.1) goods and energy (0.1) output were flat with a year ago. Meanwhile, the IHS Markit M-PMI (49.2) for October showed manufacturing activity contracted for the first time August 2016—and was the weakest in 46 months—as a sharp reduction in new orders led to a further decline in output and export sales slipped into negative territory.

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