



MORNING BRIEFING

November 20, 2018

Thanksgiving

**We wish all of our readers a happy Thanksgiving.
The next *Morning Briefing* will be sent on Monday, November 26.**

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

(1) Thank you. (2) An abundance of earnings. (3) Tax cut, revenues, and repatriated earnings all boosting earnings this year. (4) Q3 profit margins at record highs across the board, implying solid productivity gains offsetting rising costs. (5) Still not expecting price inflation to jump, but on the lookout. (6) ECI-based measure of unit labor costs remains remarkably subdued. (7) Strong dollar keeping a lid on import price inflation. (8) In the CPI, rent inflation is looking topky, while medical care inflation remains below 2.0%. (9) Fed Governor Brainard discusses AI.

Holiday Season: Giving Thanks. This is the time of year we all give thanks to our families for being there for us. We thank our friends for being our friends. Many of us thank the men and women serving our country as first responders and in the military. I also thank our nation's founders for our political system of checks and balances. And of course, we at Yardeni Research thank you for your loyal support of our research service. We wish you all the very best of times with your family and friends during Thanksgiving.

Strategy: Earnings Cornucopia. Corporate America should give thanks to President Donald Trump for slashing the effective corporate tax rate from 35% to 21% at the end of last year. The result has been a spectacular increase in S&P 500 earnings per share, as Joe and I discussed yesterday. We want to review the Q3 data released on Friday one more time to show how truly bountiful a year this has been for earnings. The results were boosted not just by the tax cut but also by revenues and the impact of repatriated earnings on buybacks. Consider the following:

(1) *Aggregate and per-share revenues.* S&P reported that S&P 500 revenues per share rose 8.5% y/y during Q3 ([Fig. 1](#)). Joe uses the divisor provided by S&P to calculate aggregate S&P 500 revenues, which rose 6.8% y/y. The difference is attributable to index changes and net share buybacks, which rose to new record highs during the first half of this year thanks to repatriated earnings ([Fig. 2](#)).

(2) *Aggregate and per-share earnings.* At an annual rate, aggregate S&P 500 revenues came in at \$11.3 trillion during Q3 ([Fig. 3](#)). S&P data for aggregate operating earnings show that this series rose to a record \$1.4 trillion at an annual rate during Q3. That's up 30.5% y/y, with revenues accounting for 6.8 percentage points of the increase and the tax cut accounting for much of the remaining 23.7 percentage points.

On a per-share basis, Joe and I prefer the operating earnings measure compiled by I/B/E/S (formerly Thomson Reuters). It is based on industry analysts' estimates of the operating earnings reported by the corporations they follow. S&P's comparable measure relies on the estimates of S&P's own analysts on the one-time adjustments that are applied to reported earnings. The two measures tend to track one another closely, with the I/B/E/S series usually exceeding the S&P measure ([Fig. 4](#)). That's mostly

because the former does not account for the expense of stock compensation plans while the latter does.

In any event, during Q3, operating earnings per share soared 27.5% y/y based on the I/B/E/S data and 32.5% using the S&P measure.

(3) *Profit margin*. Yesterday, we reported the S&P 500 profit margin using the four-quarter-trailing sum of operating earnings as reported by the S&P. It rose to a record 11.4% during Q3. Today, let's look at the profit margin on a quarterly basis using both the S&P and I/B/E/S data for operating earnings. The former rose to 12.4%, while the latter increased to 12.8% during Q3 ([Fig. 5](#)). Both are record highs. Both were at record highs of 10.3% and 10.9%, respectively, at the end of last year before the tax cut.

As we noted yesterday, the Q3 record high in the S&P 500 profit margin is truly impressive given that many companies warned during their Q3 earnings conference calls that their labor and material costs have been rising as a result of the tightening labor market and Trump's tariffs.

US Inflation: Range-Bound. In meetings with our accounts, I am most frequently asked about the biggest risk to my optimistic outlook for the US economy and financial markets. I believe a rebound in inflation is the biggest risk. I'm not expecting it, but Debbie and I are monitoring the inflation indicators closely. Here is a brief look at some of the latest data:

(1) *Wage curve*. At long last, the Phillips wage curve appears to be making a comeback. The unemployment rate fell to 3.7% during October. It is well below the Fed's 4.5% estimate of NAIRU (the non-accelerating inflation rate of unemployment). The Employment Cost Index (ECI) for private-sector workers' wages and salaries edged up to 3.0% y/y during Q3 ([Fig. 6](#)). That is the highest rate seen since Q2-2008 for this quarterly compensation measure. Average hourly earnings, a measure of wages, rose 3.2% y/y during October. That's the highest reading since April 2009 ([Fig. 7](#)).

(2) *Productivity*. Productivity is one of the key factors that can mitigate so-called cost-push inflation, when rising labor costs are passed through into prices. The ratio of the yearly percent change in the ECI to nonfarm business productivity on the same basis has remained low at around 2.0% since the mid-1990s. This measure of unit labor costs pressure is highly correlated with the core PCED inflation rate, the Fed's preferred measure of price inflation ([Fig. 8](#)).

(3) *PPI finished goods*. The Producer Price Index (PPI) for finished goods eased to 3.4% y/y during October from a recent peak of 4.2%. It hasn't moved much above 4.0% since mid-2017. For historical comparison, the PPI for finished goods reached 9.9% and 7.2% during July 2008 and July 2011, respectively ([Fig. 9](#)). Excluding food and energy, the PPI for finished goods was 2.3% during October. That hasn't moved above 3.0% since February 2012. So there isn't any evidence that producers are rushing to raise their prices.

(4) *Import prices*. US import prices have remained subdued despite the aluminum, steel, Chinese import, and other tariffs recently imposed by the Trump administration. The US import price index was up 3.5% y/y during October, but only 0.8% excluding petroleum imports ([Fig. 10](#)).

Obviously, US import prices have less to do with domestic unemployment and more to do with the relative strength of the US dollar and the impact of recent tariffs ([Fig. 11](#)). Interestingly, US import prices from China have remained remarkably subdued, rising just 0.3% y/y last month ([Fig. 12](#)).

(5) *Consumer prices*. Despite higher wage growth, productivity and subdued producer prices as well as import prices among other factors have translated into moderate consumer price inflation. The headline

CPI was up 2.5% y/y during October, but just 2.1% when food and energy are excluded.

As we've previously discussed, rent inflation has been looking topky in the past couple of years and recently has started to come down. The CPI tenant rent inflation rate was down to 3.6% y/y during October from a recent peak of 3.9% at the start of 2017.

We have been watching for signs of a possible pickup in healthcare inflation, as we've discussed before. But so far, the CPI for medical care has remained remarkably low, up just 1.7% y/y during October ([Fig. 13](#)).

(6) *Range-bound*. Interestingly, the CPI excluding food and energy has remained range-bound above 0.5% and below 3.0% on a y/y basis all the way from the mid-1990s until now. The range became even tighter following the 2008 financial crisis, floating between about 1.5% and 2.5% ([Fig. 14](#)).

While the painful inflationary experience of the 1970s remains in the minds of many investors, inflation today poses no clear and present danger. Numerous disinflationary developments since then have contributed to the tight lid that's on inflation now ([Fig. 15](#)). Walmart went public during 1970. Fed Chairman Paul Volcker proved that monetary policy could bring inflation down rapidly by causing a severe recession. Private-sector unions lost their clout during the 1980s. The end of the Cold War at the end of that decade, and China's entrance into the World Trade Organization during December 2001 unleashed the competitive forces of globalization. The high-tech revolution that started during the 1990s enabled Amazon to perfect online shopping.

Fed Governor: On Regulating AI. Banks and brokers have embraced artificial intelligence (AI), developing and using AI applications to do things quicker, cheaper, and smarter. This summer, JPMorgan started experimenting with the use of AI in its Treasury operations, a 6/20 CNBC [article](#) reported. A bit earlier this year, Bank of America [introduced](#) Erica, its chatbot, to millions of its digital banking clients. And Morgan Stanley launched Next Best Action, an AI system that will send financial advisors' customers emails, suggestions, and information, a 10/20 CNBC [article](#) reported.

Regulators are well aware of the growing influence of AI on financial services. An 11/13 [speech](#) by Fed Governor Lael Brainard titled "What are we learning about Artificial Intelligence in Financial Services?" focused on several important ways that regulation will evolve as AI rolls out. Let's take a look:

(1) *Increasingly available to all*. While the largest banks and brokers may have the deep pockets needed to experiment with AI today, the costs are dropping quickly, and soon even the smallest players in financial services will have access to AI technology.

"Due to an early commitment to open-source principles, AI algorithms from some of the largest companies are available to even nascent startups. As for processing power, continuing innovation by public cloud providers means that with only a laptop and a credit card, it is possible to tap into some of the world's most powerful computing systems by paying only for usage time, without having to build out substantial hardware infrastructure," Brainard said. In addition, players around the world are creating gobs of data to feed into the models.

(2) *How to regulate*. Regulation should balance the importance of keeping the financial system safe with allowing innovation to flourish. Likewise, the level of regulatory scrutiny should be related to the potential risk involved with using an AI tool or process. The higher the risk involved, the greater the regulatory scrutiny that's justified, with the reverse being true as well. Heavy-handed regulation might only push AI innovation into less regulated, more opaque institutions.

Some regulations already on the books will help guide AI development. For example, the Federal Reserve's "Guidance on Model Risk Management" discusses how financial institutions should use models, including complex AI algorithms. Such models should be reviewed and challenged by a second "set of eyes" that are independent from the model's development, implementation, and use. Firms are required to confirm that the models are working as expected.

Reviewing models can be difficult when some aspects of models purchased from vendors aren't transparent enough. Regulators have rules relating to such models, requiring banks to offset this extra risk by having external controls, such as circuit breakers. There's also existing guidance that financial services firms should follow when managing their vendors.

(3) *AI defense*. Firms will need strong AI defenses because the bad guys are also developing AI systems. Brainard notes: "AI tools could be used to make Internet fraud and phishing highly personalized. By accessing data sets with consumers' personally identifiable information and applying open-source AI tools, a phisher may be able to churn out highly targeted emails to millions of consumers at relatively low cost, containing personalized information, such as their bank account number and logo."

Firms should be extremely careful about the quality and the suitability of the data being fed into their AI systems. Problems "with the input data can lead to cascading problems down the line."

(4) *AI in lending*. AI systems are being developed to look at unorthodox data points when deciding a consumer's credit quality. AI systems set up properly may increase the number of people to whom credit is made available. Conversely, biased AI systems could reduce the available credit. Brainard pointed to the human resources software used by Amazon that was trained by looking at past successful hires. Because most of the past hires were men, the software was biased against women and the Amazon dropped the software.

Here, too, consumers have some protections already on regulators' books. "Importantly, the Equal Credit Opportunity Act (ECOA) and the Fair Credit Reporting Act (FCRA) include requirements for creditors to provide notice of the factors involved in taking actions that are adverse or unfavorable for the consumer," she said. "Compliance with these requirements implies finding a way to explain AI decisions. However, the opacity of some AI tools may make it challenging to explain credit decisions to consumers, which would make it harder for consumers to improve their credit score by changing their behavior." The AI community has responded by developing "explainable" AI tools.

(5) *Many unknowns*. Because not all potential consequences are knowable, firms need to be vigilant in monitoring their AI systems. Brainard concludes: "Accordingly, we would expect firms to apply robust analysis and prudent risk management and controls to AI tools, as they do in other areas, as well as to monitor potential changes and ongoing developments."

CALENDARS

US. **Tues:** Housing Starts & Building Permits 1.240mu/1.260mu. **Wed:** Durable Goods Orders Total, Ex Transportation, and Core Capital Goods -2.4%/0.4%/0.3%, Leading Indicators 0.1%, Consumer Sentiment Index 98.3, Jobless Claims 215k, Existing Home Sales 5.21mu, EIA Petroleum Status Report, Baker Hughes Rig Count. **Thurs:** None. **Fri:** C-PMI, M-PMI, NM-PMI Flash Estimates 54.8/55.4/54.5. (Econoday estimates)

Global. **Tues:** RBA Meeting Minutes, Lowe, BOE's Carney, Haldane, Cunliffe, and Saunders Testify in London. **Wed:** Japan Headline, Core, and Core-Core CPI 1.4%/1.0%/0.4% y/y, OECD Economic

Outlook. **Thurs:** Eurozone Consumer Confidence, Japan Machine Tool Orders, ECB Publishes Account of October 25 Policy Meeting. **Fri:** Eurozone, Germany, and France C-PMI Flash Estimates 53.0/53.1/53.9, Eurozone, Germany, and France M-PMI Flash Estimates 52.0/52.2/51.3, Eurozone NP-PMI Flash Estimates 53.6/54.5/55.0, Germany GDP -0.2%q/q/1.1%y/y, Canada Headline & Core CPI 2.1%/1.9% y/y. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings rose for MidCap last week, but fell for LargeCap and SmallCap. The three indexes are continuing the declines that began in mid-October during the Q3 earnings reporting season. The three-week decline for LargeCap is its first since December 2015, when it fell for three straight weeks in response to tumbling oil prices. LargeCap's forward EPS dropped four cents w/w to \$175.24 and is now 0.1% below its record high four weeks ago. Still, that's better than the declines from the peaks for MidCap (-0.2%, last record high October 19) and SmallCap (-2.0, October 26). Forward earnings activity has been relatively strong in the past 12 months: LargeCap's forward earnings have risen in 46 of the past 52 weeks, MidCap's in 47, 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 has clearly peaked. In the latest week, the rate of change in LargeCap's forward earnings fell to 21.4% y/y from 21.6%. 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 was steady at 22.7%, 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 a five-month low of 30.7% from 31.2% 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 (23.3%, 8.6%, 10.4%), MidCap (21.8, 11.0, 11.8), and SmallCap (27.0, 13.9, 13.7).

S&P 500/400/600 Valuation ([link](#)): Forward P/E ratios fell broadly last week, but remain above late October's levels, which were the lowest since before Trump's election. LargeCap's weekly forward P/E fell w/w to 15.6 from 15.9, 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 dropped to 15.0 last week from 15.1, which is up from 14.4 at the end of October in the lowest reading 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 down to 16.0 last week from 16.1, 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 fell w/w to 1.93 from 1.97, which is down from a record high of 2.19 on January 26; MidCap's decreased to 1.18 from 1.20, which compares to its record high of 1.40, also on January 26; and SmallCap's dropped to 0.94 from 0.95, 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 continue to make adjustments to their Q4 forecasts. Last week, the S&P 500's blended Q3-2018 EPS forecast rose \$0.11 w/w to \$42.64. That's up 3.8% since the end of Q2, up 13.0% ytd, and up 13.7% since the passage of the Tax Cuts and Jobs Act. The \$42.64 estimate represents a

forecasted pro forma earnings gain for Q3-2018 of 28.1%, up from 27.8% 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 28.1% 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 28.1% 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 (115.8% in Q3-2018 vs 124.0% in Q2-2018), Financials (44.7, 27.5), Materials (29.2, 40.6), Tech (28.5, 29.0), S&P 500 (28.1, 24.9), Communication Services (26.1, 18.1), Consumer Discretionary (24.9, 21.5), Industrials (18.9, 20.2), Health Care (16.4, 18.4), Consumer Staples (11.1, 13.9), Utilities (11.0, 8.7), and Real Estate (5.3, 3.3). On an ex-Energy basis, analysts expect S&P 500 earnings to rise 24.7% 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 fallen for 10/11 sectors since the end of Q3, and increased for one. Energy is the best performer, with its Q4-2018 forecast up 3.9% versus a 2.2% decline for the S&P 500. Materials is the biggest decliner, with its Q4-2018 forecast down 15.3% since the end of Q3, followed by Utilities (-6.8), Real Estate (-5.8), Industrials (-4.7), Communication Services (-4.0), Consumer Discretionary (-3.7), and Consumer Staples (-3.5).

S&P 500 Q3 Earnings Season Monitor ([link](#)): With over 92% 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 462 companies in the S&P 500 that have reported through mid-day Monday, 78% exceeded industry analysts' earnings estimates by an average of 6.8%; they have averaged a y/y earnings gain of 27.9%. On the revenue side, 60% of companies beat their Q3 sales estimates so far, with results coming in 1.4% above forecast and 8.7% 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 26.5% 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 1.5%, and sales rose a higher 9.8% y/y. Q3 earnings results are higher y/y for 87% of companies, vs 84% at the same point in Q2, but Q3 revenues are higher y/y for only 83% vs 86% a quarter ago. We don't expect these figures to change much as 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 the pace of growth 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.

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

Copyright (c) Yardeni Research, Inc. Please read complete [copyright and hedge clause](#).