MORNING BRIEFING
December 13, 2018

Unloved Industrious Industrials

See the collection of the individual charts linked below.

(1) Industrials will fall or rise depending on whether US-China trade war does or does not escalate. (2) So far, trade war with China may be boosting US imports before tariffs are raised and spread. (3) US production remains strong. (4) GE weighs on Conglomerates. (5) *Barron's* likes CAT. (6) Housing hammered. (7) Industrial services providers serving well. (8) Amazon is both a great disruptor and a great motivator for its competitors. (9) Did you take your pills today? (10) Walmart's robots.

Lunch at the White House. Larry Kudlow, director of the National Economic Council under President Donald Trump, invited me to speak at the White House Economic Advisers' lunch yesterday. Joining us was Jason Trennert, chairman, CEO, and chief investment strategist of Strategas. Several of the President's top economic advisers were in attendance. Their comments were off the record. I brought along a chart package with the following four talking points:

(1) *US-China Trade & National Security*. America is the crouching tiger, while China is the hidden dragon. Hiding in plain sight is that China is seeking to become a super-power before it turns into the world's largest nursing home.

(2) *Monetary & Fiscal Policies*. Fiscal policy has been stepping on the economy's accelerator, while the Fed has been tapping on the brakes. Monetary policy has been based on failed macroeconomic models and phantom variables that aren't observable.

(3) *Productivity & the Supply Side*. Rapid technological change is both disrupting and energizing our economy. The first effect tends to dampen productivity, while the second tends to boost it. Better productivity growth may be starting to show up in real wages.

(4) *The Stock Market*. The stock market has been very volatile this year as a result of the bullish and bearish mix of government policies. The volatility has been greatly exacerbated by high-frequency algorithm trading systems. It's time to bring back the uptick rule.

Industrials: Cheap for No Reason? If the US isn't on the verge of a recession—and we don't think it is—the S&P 500 Industrials sector looks extremely inexpensive. The sector's stock price index has fallen by 11.0% ytd through Tuesday's close, and its forward P/E has dropped by more than four percentage points to 14.6, compared to 19.0 roughly a year ago (*Fig. 1* and *Fig. 2*).

The sector could certainly get cheaper if the economy does fall off a cliff and earnings estimates are slashed. That could happen if the US and China can't resolve their simmering trade war. The S&P 500 Industrials sector generates 12.8% of its revenue from Asia/Pacific, according to a 12/5 *WSJ* article. Some companies in the sector may also have manufacturing operations in China that they will need to relocate if the business environment doesn't thaw.

However, if the two super-powers come to their senses, investors are looking at a rare buying opportunity. Yesterday, because things on the negotiating front were looking up, the DJIA rallied by 157.03 points. Investors were cheered by reports that China would grant foreign companies greater access to its markets, would buy more soybeans, and would reduce tariffs on automobiles. The progress followed Tuesday's short-lived rally on a tweet by President Trump saying that the US and China were having "very productive conversations." This is a market looking for a reason to head higher.

Here's how the ytd performance of the Industrials stock price index stacks up to that of the other 10 S&P 500 sectors through Tuesday's close: Health Care (10.1%), Utilities (7.0), Consumer Discretionary (4.3), Tech (3.7), Real Estate (2.4), S&P 500 (-1.4), Consumer Staples (-4.1), Industrials (-11.0), Financials (-12.6), Communication Services (-12.7), Energy (-13.0), and Materials (-14.7) (*Fig. 3*).

Let's take a look at some of the relevant economic data and dive deeper into the industries that make up the Industrials:

(1) *Still trading and trucking*. The squabbling between the US and China makes daily headlines; but, so far anyway, the disagreements haven't affected the volume of goods traded by the US. Real merchandise exports and imports rose 6.0% y/y in October and dipped by an ever so slight 0.4% m/m (*Fig. 4*).

Along the same lines, traffic at the West Cost ports is humming, and railcar loadings hit a new high in October (*Fig. 5*). Even the ATA Truck Tonnage Index hit new highs in September (*Fig. 6*).

The stock price indexes of S&P 500 transportation-related industries have had a mixed showing this year, but analysts are still optimistic about their earnings potential in 2019. The S&P 500 Railroads industry has been the standout, rising 11.9% ytd, while others are in negative territory, including Trucking (-14.2%), Air Freight & Logistics (-14.6), and Airlines (-9.9). Those stock price declines have sent the Dow Transports stock price index into negative territory (-7.4% ytd), an admittedly ominous sign for the broader markets that we'll continue to watch (*Fig. 7*).

That said, the economy continues to grow, the price of Brent crude oil has fallen recently to $60 per barrel, and analysts are calling for double-digit earnings growth in 2019 for several of these industries: Air Freight & Couriers (11.1%), Airlines (18.9), Trucking (18.7), and Railroads (12.7) (*Fig. 8*).

(2) *Manufacturers manufacturing*. Despite the handwringing over the economy, the data out of the manufacturing sector continues to be positive. Manufacturing production rose 4.6% (saar) during the three months ending October, based on the three-month average (*Fig. 9*). Both industrial production and its manufacturing subsection have been rising strongly since 2017 (*Fig. 10*).

Despite these strong macro numbers, many S&P 500 manufacturing-related industries have had a tough year. The Industrial Conglomerates stock price index has fallen 28.1% ytd, dragged down by GE, followed by Construction Machinery & Heavy Trucks (-21.7%) and Industrial Machinery (-13.4%) (*Fig. 11*, *Fig. 12*, and *Fig. 13*).

Earnings growth targets for next year belie the gloomy stock price returns this year. Cases in point: the 2019 earnings growth forecasts of analysts for Industrial Conglomerates (9.2%), Construction Machinery & Heavy Trucks (9.0), and Industrial Machinery (11.4) (*Fig. 14*, *Fig. 15*, and *Fig. 16*).

Because share prices have dropped while earnings forecasts have remained strong, forward P/Es have fallen dramatically. Here's where P/Es stand today and where they were roughly a year ago for the three industries: Industrial Conglomerates (15.3, 20.7), Construction Machinery & Heavy Trucks (9.9, 16.5), and Industrial Machinery (16.1, 20.4). An article in last weekend's *Barron's* favorably discussed Caterpillar, a member of the S&P 500 Construction Machinery & Heavy Trucks industry. Despite the company's sharp stock price decline, it enjoys improved margins, lean dealer inventories, and a strong sales pipeline. China represents 5%-10% of sales.

(3) *Housing humbled*. One area of the economy that has shown cracks is housing. The 10-year Treasury yield's move from roughly 2% at the end of last year to north of 3% a few months ago made financing homes more expensive and put a damper on sales (*Fig. 17*). New home sales dropped 8.9% y/y in October and are now 23.6% below their November 2017 peak (*Fig. 18*). The slowdown in sales sent inventories of new homes available for sale climbing (*Fig. 19*). Nonresidential construction has held up a bit better (*Fig. 20*).

Nonetheless, stocks with any relation to housing or building have been clobbered this year. The S&P 500 Building Products stock price index has fallen 21.0% ytd, and the Construction & Engineering stock price index is down 21.4% (*Fig. 21* and *Fig. 22*). Earnings expectations for 2019 are modest for the Building Products industry (7.9%), but much more optimistic for Construction & Engineering (27.9) (*Fig. 23* and *Fig. 24*). Both industries have forward P/Es that are lower than the S&P 500: Building Products (12.2) and Construction & Engineering (11.5).

(4) *Services lead*. The service-providing industries within the Industrials sector have outperformed the sector and the broader market. The Diversified Support Services industry's stock price index has jumped 6.3% ytd, while Environmental & Facilities Services has gained 2.5%, and Human Resources & Employment Services has risen 6.9%. Those three industries are expected to grow earnings next year by 16.3%, 5.8%, 10.1%, respectively. Their strong performances this year have left them with forward P/Es that aren't as attractive as the P/Es of industries that have sold off sharply this year. Here's where the three industries' forward P/Es stand: 22.7, 21.5, and 15.4.

If a recession doesn't come along, Industrials stocks look positioned to soar. And even if one does come along, the shares might not get too punished because they're already pricing in a lot of bad news.

Consumer Discretionary: Retailers Arise. Never underestimate the power of fear to motivate. Amazon's entrance into the business of selling drugs and groceries has prompted traditional retailers to innovate more rapidly than we've ever seen—testing new delivery methods, entering joint ventures, and embracing technology as never before. Let's take a look at some of the recent developments:

(1) *Faster drug delivery*. This summer, Amazon acquired PillPack, an online pharmacy that delivers drug packets with presorted doses of multiple medications. The deal was seen as jumpstarting Amazon's entrance into the new category.

"The PillPack acquisition gives Amazon a foothold in the regulated pharmacy business. PillPack has pharmacy licenses in all 50 states and brings in-house expertise that could help Amazon move more quickly into a space filled with regulatory obstacles," said Michael Rea, chief executive of Rx Savings Solutions, in a 6/28 *Washington Post* article.

The competition isn't standing still. Last week, Walgreens announced it has partnered with FedEx to provide national, next-day prescription delivery for $4.99, starting with 7,100 of the 9,560 Walgreen pharmacies; same-day delivery will be available in Dallas, Chicago, New York City, Gainesville, Miami, Tampa, and Fort Lauderdale. This deepens an existing relationship with FedEx, which already has counters in Walgreens stores where customers can drop off or pick up FedEx packages, a 12/8 Business Insider article reported.

CVS started offering delivery of prescriptions and over-the-counter products through the US Postal Service this summer. CVS charges $4.99 for one- or two-day delivery and $8.99 for same-day delivery, which is available in New York City, Boston, Miami, Philadelphia, San Francisco, and Washington, DC.

Both retailers are also providing more health services in their stores to get customers through the door. CVS has more than 1,100 retail MinuteClinics in CVS and Target stores, staffed by nurse practitioners and physician assistants. Walgreens has also increased the services available in its retail stores, and it is partnering with UnitedHealth Group's Optum by opening Walgreens stores next to Optum's MedExpress urgent care centers.

If they can provide care less expensively, expect the health insurers to get on board. These small clinics "are emerging as a model health insurers want to do business with as fee-for-service medicine gives way to value-based care that keeps patients out of the hospital," noted a 10/2 article in *HeatlhLeaders*. The threat to the hospital industry is a story for another day.

CVS and Walgreens are also entering the insurance business. CVS closed on its $70 billion acquisition of Aetna last month, while Walgreens and Humana are talking about swapping equity stakes. One can imagine a day when an insurer might direct where you purchase your prescriptions or receive care.

(2) *Battling over bananas*. Amazon's 2017 acquisition of Whole Foods has also pushed retailers to get creative. Last week, Kroger announced plans to sell groceries in the branded sections of Walgreens.

A 12/4 *WSJ* article reported: "The first 'Kroger Express' sections will open by early next year in 13 Walgreens stores near the grocer's Cincinnati headquarters. The companies said they would add more of the 4,000-square-foot displays of produce, Home Chef meal kits and other products if customers take to them. They will account for roughly a third of an average Walgreens selling space."

(3) *Harnessing technology.* Meanwhile, Walmart has been both making acquisitions and using technology to keep its offerings fresh and lower its costs. Walmart has purchased online retailers Shoes.com, Moosejaw, Bonobos, Eloquii, Jet.com, and Bare Necessities, in addition to delivery companies Parcel and Cornerstone. Internationally, it has expanded online by buying Flipkart in India.

Last week, Walmart introduced 360 robotic floor sweepers that look like a small Zamboni and act like a Roomba, a 12/4 *Washington Post* article explained. The machines can both scrub floors and collect data about their environment, including information on store traffic and empty shelves.

Another Walmart robot has a tall tower that scans shelves to see if they're stocked. A human is still needed to restock the shelf when necessary. A potential fly in the ointment: teenagers kicking and pulling pranks on the machines, noted a 3/26 Fortune article. So the robots are built to withstand being hit with cans of tomato soup!

Walmart is also testing a robot that can gather items ordered online from a store's storage area and deliver them to a human packer who prepares the order for in-store pickup, according to an 8/3 article in Engadget. "Alphabot is the latest technology to be tested by Walmart. Other pilots include shelf-scanning inventory robots, self-driving floor-scrubbing robots and a partnership with Waymo that provides autonomous vehicle transportation for grocery order pickup. Walmart has also been expanding its Pickup Tower feature as well as its grocery delivery service with the help of DoorDash and Postmates. Looking to the future, recent patents filed by the company include designs for smart carts, wearables, a drone and an audio surveillance system," the article explains.

Who would have expected the retailer with humble Bentonville, Arkansas roots to evolve into a hotbed of innovation?

CALENDARS

US. Thurs: Jobless Claims 228k, Import & Export Prices -1.0%/0.1%, EIA Natural Gas Report. **Fri:** Retail Sales Total, Ex Autos, Ex Autos & Gas, and Control Group 0.1%/0.2%/0.4%/0.4%, Total & Manufacturing Industrial production 0.3%/0.2%, Capacity Utilization 78.5%, Business Inventories 0.6%, C-PMI, M-PMI, NM-PMI Flash Estimates 54.4/55.4/54.4, Baker-Hughes Rig Count. (Econoday estimates)

Global. Thurs: Germany CPI 0.1%m/m/2.3%y/y, Japan Tankan Large Manufacturing & Non-Manufacturing Indexes 18/21, Japan Tankan Large Manufacturing & Non-Manufacturing Outlooks 17/20, Japan Tankan Large All Industry Capex 12.8%, ECB Rate Decision 0.00%, ECB Marginal Facility & Deposit Facility Rates 0.25%/-0.40%, Summit of EU Leaders. **Fri:** European Car Sales, Eurozone, Germany, and France C-PMI Flash Estimates 52.8/52.4/54.0, Eurozone, Germany, and France M-PMI Flash Estimates 51.l8/51.7/50.7, Eurozone, Germany, and France NM-PMI Flash Estimates 53.4/53.5/54.8, Japan M-PMI Flash Estimate, Japan Industrial Production, China Retail Sales 8.8% y/y, China Industrial Production 5.9% y/y, China Fixed Assets Ex Rural (ytd) 5.9% y/y, Summit of EU Leaders. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): Our Bull/Bear Ratio (BBR) climbed further above 2.00 this week, after dipping below two weeks ago for the first time in just over two years. The BBR advanced for the second week this week to 2.23, after falling the prior two weeks from 2.26 to 1.86—which was the lowest reading since the week of November 8, 2016. Bullish sentiment slipped to 45.4% this week after rising from 38.3% (which was the lowest percentage since late May 2016) to 46.7% last week; it was as high as 61.8% ten weeks ago. Bearish sentiment declined for the first time in four weeks, to 20.4%, after climbing the prior three weeks, from 19.0% to 21.5%—the highest reading since November 2016. The correction count advanced to 34.2% after sinking to 31.8% last week; it had jumped 21.5ppts the prior eight weeks to 41.1%—the highest percentage since late September 2015. The AAII Ratio increased for the second week last week, from 34.9% to 55.4%, as bullish sentiment rose from 25.3% to 37.9% over the two-week period, and bearish sentiment fell from 47.1% to 30.5%.

S&P 500 Earnings, Revenues & Valuation (*link*): S&P 500 consensus-per-share forecasts edged down for forward revenues last week, but rose for forward earnings. Forward revenues is less than 0.1% below its record high a week earlier, but forward earnings is at a record high again for the first time since early November. 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 8.6%, compared to 6.0% and 9.4% 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 July 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, forecasts were steady w/w at 8.8% for 2018 and 5.8% for 2019%. The annual earnings growth forecasts were steady too, at 24.0% for 2018 forecast and 8.3% for 2019. The forward profit margin edged up 0.1ppt w/w to 12.3%, and is now down 0.1ppt from a record high of 12.4% in mid-September. Still, 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 was steady at 6.2%, but forward earnings growth fell 0.7ppt to 8.3%. The S&P 500 ex-Financials forward profit margin edged up 0.1ppt w/w to 11.4% and is down from a record high of 11.5% in mid-September, but that's still up from 10.4% before the TCJA. As the market rallied sharply last week, valuations rose from multi-year lows. The S&P 500's forward P/E was down to 15.5 from 15.9, which compares to 15.3 the week before that in the lowest reading since February 2016, and to a 16-year high of 18.6 at the market's valuation peak in late January. The S&P 500 price-to-sales ratio fell to 1.90 from 1.94.

S&P 500 Sectors Earnings, Revenues & Valuation (*link*): Consensus forward revenues rose w/w for eight of the 11 sectors and forward earnings rose w/w for 10/11 sectors. Consumer Staples, Energy, and Health Care had forward revenues fall w/w, and Real Estate had forward earnings decline. 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 earnings has about tripled from the 18-year low in April 2016, but has likely peaked for now. 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 1.05 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 eight of the 11 sectors, all but Communication Services, Health Care, and Real Estate. During the latest week, the forward profit margin rose for 7/11 sectors and fell for Real Estate. Here's how the sectors rank based on their current forward profit margin forecasts: Information Technology (22.8%), Financials (19.2), Real Estate (15.4), Communication Services (14.8), Utilities (12.8), S&P 500 (12.3), Materials (11.0), Health Care (10.6), Industrials (10.2), Energy (7.8), Consumer Staples (7.6), and Consumer Discretionary (7.5).

US ECONOMIC INDICATORS

CPI (*link*): The core CPI rate in November returned to the August and September rates of 2.2%, after easing to 2.1% in October; it remains below July's 2.4%, which was the fastest pace since September 2008. The rate held above the Fed's target rate of 2.0% y/y for the ninth straight month. Here's a ranking of the core goods rates, from lowest to highest: Apparel (-0.4% y/y), new vehicles (0.3), medical care commodities (0.6), alcoholic beverages (1.8), used cars & trucks (2.3), and tobacco & smoking products (3.4)—with only the last two surpassing the total core rate of 2.2%, though used cars & trucks just barely. Here's the same exercise for the core services rates: Airfares (-1.6), physicians' services (0.8), motor vehicle maintenance & repair (2.7), owners' equivalent rent (3.3), hospital services (3.5), rent of primary residence (3.6), and motor vehicle insurance (5.5)—with only the rate for motor vehicle maintenance & repair on an accelerating trend. The core CPI three-month rate accelerated 2.1% (saar) after slowing to a 15-month low of 1.6% in October; this rate has fluctuated from 1.6% to 2.3% over the last eight months. The headline CPI rate slowed from 2.5% to 2.2% y/y—the lowest rate since the start of the year. It's down from a recent peak of 2.9% in June and July, which was the highest since February 2012.

PPI (*link*): The Producer Price Index for final demand in November slowed to a near standstill after posing its biggest monthly increase in six years in October. Prices edged up 0.1% last month after jumping 0.6% in October; prices had increased only 0.1% during the three months through September. Prices for final demand goods contracted -0.4% after a 0.6% gain and a -0.1% loss the prior two months, driven by a -14.0% drop in gasoline prices. The comparable services measure saw price gains slow to 0.3%, nearly half October's 0.7% pace, with most of the gain being traced to margins for fuels and lubricants retailing, which jumped 25.9%. The yearly inflation rate for the headline series slowed to 2.5% y/y—its smallest rate this year, and down from 3.4% in July—as the yearly rate for final demand goods eased steadily from 4.4% in July to a 17-month low of 2.2% last month. Meanwhile, the yearly rate for final demand services accelerated from 2.2% in August to 2.6% y/y in November. The core rate accelerated from 2.3% in August to 2.7% y/y in November; the rate for core ex trade services remained just below 3.0%, at 2.8% y/y.

GLOBAL ECONOMIC INDICATORS

Eurozone Industrial Production (*link*): October output in the Eurozone remained stalled around last November's cyclical peak—just 0.8% below. Industrial production (excluding construction) ticked up 0.2% after a downwardly revised -0.6% (from -0.3%) decrease in September and an upwardly revised 1.2% (from 1.1) increase in August. Of the main industrial groups, only capital goods is showing any signs of life, advancing for the fifth time in seven months, by 1.0% m/m and 5.3% over the period—back up at November's record high. Production of consumer nondurable goods was on a volatile uptrend, but has stalled around recent highs, showing no change in October after falling three of the past four months by a total of -1.5%. Meanwhile, output of consumer durable goods rose for the second time in three months, by 1.2%, though is still down -2.8% ytd; intermediate goods production ticked up 0.2% in October after falling three of the previous four months by -1.0%. October production data are available for the top four Eurozone economies, and show production rose in France (1.2) and Spain (1.2), and fell in Germany (-0.6), while Italy's (0.1) was little changed. It was the first increase in French production in three months, and the second in three months for Spain—though the three-month gain of 1.0% was below October's 1.2% increase. Production in Italy has been very volatile the past four months, with output flat over the period. Among the Eurozone economies for which data are available, the highest increases in industrial production in October were registered in Lithuania (7.4) and Slovenia (2.5); the largest decreases were observed in Finland (-2.6), Greece (-1.5), and Latvia (-1.2).

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