



MORNING BRIEFING

December 19, 2018

European Disunion

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

(1) Analysts starting to cut earnings estimates for 2019 and 2020. (2) Tough comps ahead. (3) Analysts still remarkably upbeat about revenues outlook. (4) But they are lowering their earnings estimates for Q4-2018 through Q4-2019. (5) After 20 years of monetary unification, Eurozone faces lots of challenges. (6) The Brits may be leaving the EU at a good time if forces of disunion mount. (7) Bad timing: ECB moving to normalize policy as Eurozone economy weakens. (8) Brexit is hard to do. (9) Political agitations in France, Germany, and Italy.

Strategy: Analysts Curbing Their Enthusiasm. Joe and I curbed our enthusiasm for the S&P 500 earnings outlook at the end of October. Now industry analysts are doing so as well. Keep in mind that they have only just started to lower their estimates, which remain well above our own for 2019 and 2020. Of course, investors haven't been waiting for the analysts, as evidenced by the severe drop in valuation multiples since the record high in the S&P 500 on September 20.

The problem, as we have observed before, is that comps are going to be tough in the coming year following this year's earnings, which were boosted by the tax cut, record profit margins, and above-average growth in revenues. This suggests that earnings growth at best should be in the low single digits next year, not the high single digits as analysts still expect. Investors perceive that the risk is on the downside if the trade war persists next year, if global economic growth slows, and if profit margins get squeezed. Let's look at the latest data:

(1) *Annual revenues and earnings estimates.* Remarkably, consensus analysts' expectations for S&P 500 revenues during 2019 and 2020 remained on uptrends during the 12/6 week even though a slowdown of revenues growth is expected, from 8.8% this year to 5.8% next year and 4.6% in 2020 ([Fig. 1](#) and [Fig. 2](#)).

In the past few weeks, the analysts have started to reduce their earnings estimates for the next two years ([Fig. 3](#)). The 2019 earnings growth rate has been lowered from a high of 10.3% during the 10/7 week to 8.5% during the 12/6 week ([Fig. 4](#)). The growth rate for 2020 remains around 10%.

Joe and I are currently projecting revenues growth of 5%, and the same for earnings growth. Our earnings estimate for next year is \$170 per share, while the analysts are well above us at \$175.60.

(2) *Quarterly earnings estimates.* Analysts are doing what they typically do as an earnings season approaches: They are cutting their estimates ([Fig. 5](#)). The growth rate for Q4-2018 has been reduced from 18.2% at the end of September to 14.5% currently ([Fig. 6](#)). That's not unusual. They often do so only to find that the earnings season was better than their downwardly revised estimates. What is unusual is that they've been lowering their estimates for all four of next year's quarters, which is reflected in their 2019 estimate ([Fig. 7](#)).

(3) *Next year's profit margin.* The strength in consensus revenues estimates relative to consensus earnings estimates shows that analysts are starting to chip away at their profit margin expectations ([Fig. 8](#)).

(4) *Bottom line.* So we are still expecting revenues and earnings to grow next year because we aren't in the recession camp. It's just that we foresee slower growth than analysts are expecting, and their expectations are very likely to come down to our numbers. The latest correction seems to be discounting the possibility that earnings growth will be flat to down next year. We doubt it, but the jury is out.

European Union I: Happy Anniversary? January 1 marks the 20th anniversary of the Eurozone's adoption of the euro as the region's official single currency. There is good reason to celebrate, especially since skeptics have been predicting the euro's demise since its inception. But hold the bubbly. Other than a #EUROat20 hashtag on Twitter and an [event](#) in Brussels held earlier this month, the day is likely to come and go with little commemoration and seems to be actively being downplayed.

Two decades on, the Eurozone and its single currency continue to confront more than their share of critics, as nationalistic and anti-democracy movements gain traction in the region and the current US administration heaps criticism on the bloc, even referring to it as a "foe," as a 12/24 *New Yorker* [article](#) points out. It's a sharp contrast to the hoopla that greeted the then electronic-only currency when it made its trading debut on January 4, 1999.

Launched first on the Frankfurt Stock Exchange by virtue of an 8:30 a.m. start, the occasion was marked with flashing blue lights, images of the euro projected on the wall with a sign declaring "Der Euro Ist Da" ("The Euro Is Here"), and Beethoven's *Ode to Joy* broadcast across the trading floor, according to a 1/5/99 [report](#) in the *Washington Post* marking the historic event. In a sign of the giddiness surrounding its introduction (with some imagining the new currency challenging the US dollar as the world's reserve currency), the euro closed that first day at \$1.1747 from the \$1.1686 value assigned to it. Thin trading volume also helped give it a lift. Still, its value quickly depreciated by the end of the year, and G7 countries stepped in to support the fledgling currency ([Fig. 9](#)). Only when physical coins and notes began widely circulating in 2002, replacing the legacy currencies of the individual nations, did the euro begin to appreciate markedly.

The goal of the single currency: stimulating trade by establishing stable, secure, and transparent cross-border pricing, reducing costs, and strengthening the Eurozone's hand in global commerce. The challenge: managing monetary and fiscal policy in a way that balances the needs of all members. The vision: European unity.

Fast-forward to today. After rising through much of 2017 and reaching a three-year high of \$1.24 in early 2018, the euro ended Monday at \$1.136, down 5.3% ytd and off 8.0% from its January high. It reached an all-time high of \$1.60 in July 2008 before being dragged lower by the global financial crisis that unfolded later that year.

Political unrest in France, political uncertainty surrounding the UK's "Brexit" departure from the broader European Union (EU), political defiance from Eastern European members of the EU, political change in Germany, and a political standoff with Italy over its proposed budget have strained both the EU and the Eurozone. A serious economic slowdown looms across the region, exacerbated by global trade wars and a slump in auto sales. To top it off, the European Central Bank (ECB) is ending its three-year QE stimulation program this month and suggesting the possibility of raising interest rates in the fall of 2019. Not since the debt crisis has the EU faced such serious tests. Let's review what currently ails the EU:

(1) *Business lagging.* Growth in business activity across the EU slowed in December to the weakest level in four years, according to a 12/14 IHS Markit Flash PMI [survey](#). The Flash Eurozone Composite Output Index fell from 52.7 last month to 51.3 in December, the lowest reading in 49 months ([Fig. 10](#)). New business orders came to a near standstill, job creation fell to a two-year low, and business optimism faded further.

The Eurozone's economic sentiment index—which is highly correlated with real GDP growth—has been in a downtrend since late 2017 ([Fig. 11](#)). Auto sales weakness in the EU and violent protests in France have played a role. Yet Chris Williamson, the chief business economist at IHS Markit, noted “the weaker picture also reflects growing evidence that the underlying rate of economic growth has slowed across the euro area as a whole.”

(2) *ECB cuts forecasts.* ECB President Mario Draghi last week cut growth forecasts for the Eurozone to 1.9% in 2018, down from 2.0% projected in September, reported a 12/13 CNBC [article](#). Also, estimates for 2019 GDP growth were revised lower to 1.7% from 1.8%. Draghi noted the “balance of risk is moving to the downside” and cited the “persistence” of geopolitical factors, protectionism threats, as well as emerging market “vulnerabilities” and volatility in the financial markets.

(3) *ECB ceases bond-buying.* The ECB issued a 12/13 [statement](#) prior to Draghi's press conference confirming that its asset purchase program will end this month. The central bank revealed it plans to reinvest principal payments from maturing bonds for an extended period, past the date when it starts raising key rates and “for as long as necessary to maintain favorable liquidity conditions and ample monetary accommodation.” The central bank will keep interest rates at current levels “at least through the summer of 2019” ([Fig. 12](#)).

(4) *MSCI Valuation.* On a local currency basis, the MSCI EMU Share Price Index is the second worst performer ytd of the 49 countries tracked, down 12%. Only Emerging Markets Asia has fared worse, with a drop of 13.5%. Its decline of 10.1% in Q4 to date puts it just ahead of the Developed World ex-US's loss of 10.4% so far this quarter. The story changes in dollar terms, with the MSCI EMU Share Price Index dead last in the performance derby, with a loss of 17.1% ytd and down 12.5% Q4 to date. Except for Telecommunications and Utilities, all of the MSCI EMU sectors are trading below their 200-day moving averages ([Fig. 13](#)).

European Union II: Brexit Pains. Chief among the contributors to economic uncertainty in the EU is the UK's tortuous attempt to leave the union as directed by its citizens following a referendum in June 2016. While it opted out of joining the monetary union, the UK has been a member of the EU common market for 40 years. Here are the latest developments of the circus-like spectacle known as “Brexit,” which we covered at length in the 11/28 [Morning Briefing](#):

(1) *Shelved vote.* Prime Minister Theresa May postponed a parliamentary vote last week on her Brexit agreement with the EU, acknowledging that it would be defeated by a wide margin, according to a 12/10 BBC [report](#).

(2) *Move to shelve PM.* The shelved vote led to a movement by members of her own Conservative party to shelve May. She won the confidence vote by 200-117, but emerged badly diminished from the fray and now faces the prospect that no deal she proposes will be backed by Parliament, as a 12/12 WSJ [article](#) pointed out. A bid by May to secure more concessions from EU leaders failed.

(3) *New vote.* May scheduled more parliamentary debate for January 7, with a vote on the agreement to come a week later, moving the country closer to a “her deal or no deal” choice, despite calls for a second referendum. An EU court ruled that the UK could unilaterally cancel Brexit, but May has

dismissed that option as a betrayal of the voters' rights, according to a 12/10 *Guardian* [article](#).

(4) *Currency sell-off*. The pound has lost 6.6% ytd, ending Monday at \$1.26 amid growing prospects of a chaotic and disorderly exit from the EU and concerns about the Labour party gaining power if May's government falls ([Fig. 14](#)).

(5) *Capital flight*. Credit Suisse has advised its ultra-wealthy clients to consider accelerating plans to move assets out of the UK ahead of the January 14 vote, according to a 12/18 [piece](#) in the *FT*.

(6) *MSCI valuation*. The MSCI UK Share Price Index has fallen 11.0% ytd in local currency terms and is off 8.80% qtd. In dollar terms, the UK index is off 17.4% ytd and 12.1% qtd ([Fig. 15](#)).

European Union III: Continental Discontent. A funny thing happened as French President Emmanuel Macron was busy pushing his bold economic reform plans while focusing on holding the center of the EU together: He overlooked the wave of discontent roiling the middle and under classes in his own country. That discontent erupted in November in violent street protests known as the “*Gilet Jaunes*,” or “Yellow Vests,” movement, so-called because of the demonstrators' reflective vests.

Higher fuel taxes and reduced job protections, amid regulatory rollbacks for businesses and the repeal of a wealth tax, sparked the demonstrations. Macron, his approval ratings plummeting, responded immediately by suspending the fuel tax increase for six months, raising the minimum wage, cancelling a planned tax increase on low-income pensioners, repealing a tax on overtime pay, and encouraging employers to pay a year-end bonus. He easily survived a no-confidence vote in the French parliament because of his responsiveness, observed a 12/13 *WSJ* [piece](#).

The new measures have put France's budget on track to reach 3.4% of GDP in 2019, exceeding the EU's limit of 3.0% of GDP and its previous budget proposal of 2.8%, according to a 12/16 Reuters [article](#). Due to the budget squeeze, France will move independently to impose a tax on international tech giants such as Google and Facebook beginning January.

Italy's hardline deputy prime ministers, meanwhile, softened their stance and agreed to cut planned spending to appease Brussels and avoid sanctions. Under a proposal, Italy will produce a budget of 2.0% of GDP instead of the 2.4% initially put forth, according to a 12/17 *FT* [report](#).

Germany's CDU party elected to embrace continuity and the legacy of Chancellor Angela Merkel by electing her protégé Annegret Kramp-Karrenbauer as its new leader in elections held December 7.

The only reason to break out the bubbly in the EU is that New Year's is coming.

CALENDARS

US. Wed: Existing Home Sales 5.190mu, MBA Mortgage Applications, Current Account -\$124.9b, EIA Petroleum Status Report, FOMC Announcement 2.375% (2.25% to 2.50%), Powell. **Thurs:** Leading Indicators 0.0%, Jobless Claims 220k, Philadelphia Fed Manufacturing Index 16.5, EIA Natural Gas Report. (Econoday estimates)

Global. Wed: UK Headline & Core CPI 2.3%/1.8% y/y, Canada Headline & Core CPI 1.8%/1.9% y/y. **Thurs:** UK Retail Sales Including & Excluding Fuel 2.0%/2.3% y/y, Japan CPI Headline, Core, and Core-Core 0.8%/1.0%/0.4% y/y, Australia Employment Change & Unemployment Rate 20k/5.0%, BOE Bank Rate & Asset Purchase Target 0.75%/£435b, BOJ Bank Rate. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Buybacks ([link](#)): S&P 500 quarterly buybacks rose 6.9% q/q to a record-high \$203.8 billion during Q3-2018, and its 57.7% y/y gain was its second strongest since Q1-2014. The \$203.8 billion reading is the highest quarterly buyback amount on record, dating back 83 quarters to Q1-1998, and exceeds the prior cycle's record high of Q3-2007 by 18.5%. Furthermore, the quarterly buyback amount improved q/q for a fifth consecutive quarter—the first time that's happened since Q4-2013. The four-quarter sum of buybacks jumped 11.5% q/q to a record high of \$720.4 billion from \$645.8 billion. S&P 500 buybacks in Q3 accounted for 0.83% of the total market capitalization for the S&P 500, unchanged from Q2 and down a whisker from Q1's eight-quarter high of 0.84%. That compares to 0.60% during Q4, which was the lowest since Q1-2010, as well as a cyclical peak of 1.15% in Q3-2011 and a record high of 1.28% during Q3-2007.

S&P 500 Sectors Buybacks ([link](#)): Buybacks rose q/q during Q3-2018 for six of the 11 sectors and fell for five. That compares to seven rising and four falling during Q2-2018. Due to changes in the GICS classification scheme, which saw the Media industry and some Tech companies move to Communication Services, that sector was the biggest q/q buyback gainer on a percentage basis in Q3-2018, rising over 2,000% q/q to a record high of \$10.1 billion from \$419 million. The biggest percentage q/q gainers among the remaining 10 sectors: Energy (up 71.1% q/q to \$7.3 billion from \$4.3 billion), Consumer Staples (52.4%, to \$10.0 billion from \$6.6 billion), Financials (35.6%, to a record high of \$40.6 billion from \$30.0 billion), Utilities (23.2%, to a 13-quarter high of \$509 million from \$413 million), and Tech (15.1%, to a record high of \$82.3 billion from \$71.5 billion). The biggest percentage q/q decliners: Health Care (-46.8%, to a four-quarter low of \$14.4 billion from a \$27.2 billion), Real Estate (-41.2%, to a seven-quarter low of \$520 million from \$884 million), Industrials (-35.3%, to \$15.2 billion from \$23.4 billion), Consumer Discretionary (-13.1%, to \$19.7 billion from \$22.7 billion), and Materials (-6.9%, to \$3.0 billion from \$3.2 billion). Tech accounted for the biggest portion of total S&P 500 buybacks in Q3-2018 for a fourth straight quarter, improving to a record-high 40.4% share from 37.5% in Q1. Tech had held the top spot for 16 straight quarters through Q3-2016 before trading places with Financials and Health Care for four quarters through Q3-2017. Financials' share was second as it improved to 19.9% from 15.7% in Q2, and Consumer Discretionary's share was third, dropping to 9.7% in Q3 from 11.9% in Q2. Industrials' was fourth (down to 7.4% from 12.3%), and Health Care's was fifth (down to 7.1% from 14.3%).

S&P 500 Cash Return & Buyback Yield ([link](#)): During Q3-2018, the S&P 500 companies continued their long-established trend of spending more on buybacks than dividends, as record-high buybacks of \$203.8 billion outpaced the record-high quarterly dividend payments of \$115.2 billion. Buybacks have exceeded dividends in 43 of the past 48 quarters, except during the financial crisis from Q4-2008 to Q4-2009, when all sectors cut buyback spending drastically. With the pace of buybacks and dividends rising in Q3, the four-quarter sum of buybacks and dividends, or cash returned to investors, improved for a sixth straight quarter to a record high of \$1.2 trillion from \$1.1 trillion during Q2. The four-quarter cash return rose 7.8% q/q and is up 28.5% from a nine-quarter low of \$906.7 billion during Q2-2017. It exceeds the prior record high of \$974.6 billion in Q1-2016 by 19.5%. On a brighter note, companies earned more than they paid out to investors for a seventh straight quarter after six straight quarters of earning less. More specifically, Q3-2018's four-quarter sum of operating earnings, at a record-high \$1.277 trillion, exceeded the \$1.165 trillion returned to investors. The cash return was 8.8% lower than trailing-four-quarter operating earnings during Q3, little changed from 9.7% during Q2. The S&P 500's Q3 figures are better on an ex-Energy basis. Operating earnings exceeded the cash return for an eighth straight quarter as the percentage rose to 90.5% from 89.0%; it compares to a 28-quarter high of 102.2% in Q2-2016. Including Energy, the S&P 500's buyback yield jumped to a nine-quarter high of 2.93% from 2.80%, and is up from a 31-quarter low of 2.28% in Q4-2017. However, the dividend yield fell to a 30-quarter low of 1.81% from 1.89% in Q2. Adding both Q3 figures together, the buyback +

dividend yield (or cash return) edged up to a seven-quarter high of 4.74% in Q3 from 4.69% in Q2.

S&P 500 Sectors Cash Return & Buyback Yield ([link](#)): During Q3-2018, eight of the 11 sectors had enough operating earnings on a trailing-four-quarter basis to cover their buybacks and dividends (cash returned to investors), down from nine in Q2-2018. Consumer Staples covered its cash return for a second straight quarter after missing for 13 quarters, Industrials covered its cash return for a sixth quarter after missing for seven straight quarters, Consumer Discretionary did so for a seventh quarter after missing for 12 quarters, and Materials did so for just the eighth time in the 14 quarters since Q1-2014. On the flip side, Tech missed for the first time in eight quarters and the Energy sector missed for a 14th straight quarter. However, Energy was profitable on a GAAP operating earnings basis for a seventh quarter after five quarters of losses. Here's how the sectors' four-quarter cash returns relative to four-quarter earnings ranked in Q3-2018: Real Estate (134.4%), Tech (108.6), Energy (105.3), Communication Services (102.4), Consumer Staples (92.9), S&P 500 (91.2), Health Care (90.5), S&P 500 ex-Energy (90.5), Consumer Discretionary (89.9), Industrials (84.1), Financials (82.0), Materials (65.2), and Utilities (60.0). Looking at the four-quarter buyback + dividend yield, the percentage returns rose q/q for 6/11 sectors; here's how they ranked: Tech(6.2% [18-quarter high]), Financials (6.1 [eight-quarter high]), Consumer Staples (5.2 [five-quarter low]), S&P 500 (4.7 [seven-quarter high]), Consumer Discretionary (4.7 [four-quarter high]), Industrials (4.7), Energy (4.5), Real Estate (4.0 [only the sixth quarter for which data is available]), Health Care (4.0), Materials (3.9 [eight-quarter high]), Utilities (3.6), and Communication Services (2.5 [record low due to GICS changes]).

US ECONOMIC INDICATORS

Housing Starts & Building Permits ([link](#)): The underlying trend in housing activity remained weak last month, pushing builders' optimism this month down to its lowest level since May 2015. Housing starts rebounded 3.2% this month, to 1.256mu (saar), driven by a 22.4% jump in volatile multi-family starts to 432,000 units (saar); single-family starts slumped for the third month by -4.6% m/m and -7.4% over the period to an 18-month low of 824,000 units (saar). The latter is showing a -2.7% decline ytd. Meanwhile, building permits jumped 5.0% to 1.328mu (saar) last month, boosted by a 14.8% surge in multi-family permits to 480,000 units; single-family permits ticked up 0.1% to 848,000 units (saar) after slipping -0.8% in October; these permits are down -3.3% ytd, while multi-family are up 8.4%. Meanwhile, the National Association of Home Builders/Wells Fargo Housing Market Index (HMI) is down sharply, having plunged 12 points over the past two months to a 3.5-year low of 56. All three index components fell sharply over the period: current sales conditions (to 61 from 74), expected sales (61 from 75), and buyer traffic (43 from 53).

GLOBAL ECONOMIC INDICATORS

Germany Ifo Business Climate Index ([link](#)): "Across the board we have a less optimistic scenario here," Ifo President Clemens Fuest said in a Bloomberg TV interview. "We're not seeing a downturn here, but certainly a cooling of the economy." Overall business confidence fell for the fourth straight month, from a six-month high of 104.0 in August to a two-year low of 101.0 this month, as trade tensions and the rising risk of a no-deal Brexit threaten to hamper a meaningful economic rebound from this summer's lull. December's decline was the ninth this year. Both the present situation (to 104.7 from 106.8) and expectations (97.3 from 101.2) measures fell over the four-month period, to the lowest reading since June 2017 and November 2014, respectively. Of the four sectors, business climate indexes for the manufacturing, services, and trade sectors all deteriorated again this month, while construction's held just below October's record high. Within the trade sector, confidence was little changed for wholesaling, while retailing edged lower. Meanwhile, according to a survey of purchasing managers, Germany's private sector remained stuck in a phase of low growth in December, with its C-PMI slowing to a four-year low of 52.2.

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](#).