



MORNING BRIEFING

December 20, 2018

Unhealthy Developments

**The next *Morning Briefing* will be sent on Monday, January 7.
We wish you all the best during the holidays and the year ahead.**

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

(1) Powell is no Santa. (2) Bonds rally as stocks sink. (3) Mnuchin suspects HFTs adding to volatility. (4) Judges making Health Care sick. (5) Autonomous cars hit the road but still need driver's ed. (6) Manufacturers to China: "We're outta here."

The Fed: Powell Is No Santa. Yesterday, Fed Chairman Jerome Powell confirmed that his Fed remains independent of the White House. On Monday, President Donald Trump berated the Fed for even considering raising rates. Yet that's exactly what Powell and the Federal Open Market Committee voted to do at yesterday's monetary policy meeting. The stock market fell on the news that Powell was not wearing his Santa outfit.

Interestingly, the 10-year Treasury bond yield fell, signaling that the Bond Vigilantes are leaving it to the Dow Vigilantes to punish the Fed for its Grinch-like decision. In my opinion, by proceeding with yesterday's rate hike and suggesting that two more are on the way for 2019, the odds that there will be no rate hikes in 2019 have increased. That's confirmed by the reaction in the bond market.

I still don't expect a recession in 2019, but slower economic growth and possibly even lower inflation should dissuade the Fed from hiking rates in 2019. While the outlook for earnings growth remains challenging, as Joe and I have been discussing since late October, we are sticking with our target for the S&P 500 of 3100 by the end of next year based on our view that the economy will continue to grow in 2020.

Strategy: Mnuchin vs HFTs. As I previously reported, I attended a White House lunch of the President's top economic advisers last week on Wednesday (12/12). While I can't disclose who was there, I was pleased to read a 12/18 Bloomberg [article](#) titled "Mnuchin Blames Volcker Rule, High-Speed Trading for Volatility." This was one of the four issues I brought up in my [presentation](#). I didn't mention the Volcker Rule. But I did opine that high-frequency trading (HFTs) may account for some of the volatility in the stock market this year, and I advocated for restoring the Securities and Exchange Commission's uptick rule, which Melissa and I discussed in the 12/12 [Morning Briefing](#).

The Bloomberg article mentioned the HFT issue, but not the uptick rule. The article noted: "U.S. Treasury Secretary Steven Mnuchin blamed volatility in equity markets partly on high-speed trading and the effect of the Volcker Rule, adding that he planned to conduct an inter-agency review of market structure. ... Mnuchin said he will ask the Financial Stability Oversight Council, which he heads, to study stock market volatility. While he has not 'pre-judged' what exactly is behind the sharp moves before a review is complete, Mnuchin said problems with market structure 'may be one of the reasons.'"

Health Care: Wounded by the Courts, I. When we were sitting down for Thanksgiving dinner, the S&P 500 Health Care sector was outperforming other sectors in the index ytd. Since then, the sector's ytd gain has been halved to 4.3%. Headlines out of the judicial system calling into question the legitimacy of the Affordable Care Act (ACA) sent shares of some of the largest companies in the sector tumbling. The best-performing sector ytd is one of the worst-performing sectors so far in December.

Here's the dismal performance derby for the S&P 500 sectors in December through Tuesday's close: Utilities (-2.0%), Real Estate (-4.3), Communications Services (-4.9), Tech (-6.4), Consumer Staples (-6.9), Consumer Discretionary (-7.1), Materials (-7.5), S&P 500 (-7.8), Industrials (-8.8), Health Care (-9.1), Energy (-10.2), and Financials (-11.7) ([Fig. 1](#)).

Ytd results for the S&P 500 sectors look a bit better: Health Care (4.3%), Utilities (2.9), Consumer Discretionary (1.0), Tech (0.7), Real Estate (-2.0), S&P 500 (-4.8), Consumer Staples (-8.7), Industrials (-13.0), Communication Services (-14.2), Financials (-14.9), Materials (-16.7), and Energy (-18.1) ([Fig. 2](#)).

Let's examine what's dimming the performance of the top-performing sector as the year comes to a close:

(1) *Obamacare drama*. Last Friday, a US district judge ruled that the ACA is unconstitutional because it requires Americans to obtain medical insurance. The ruling upheld a lawsuit brought by 20 Republican states. The ACA will remain in place if the Democrats appeal the decision, as is expected.

The ruling may put Republicans in a difficult situation because the ACA has grown in popularity. There are about 11.8 million Americans enrolled in Obamacare insurance plans.

"Senior Republicans are divided over whether to continue their push to repeal the act, or whether to move instead towards more moderate bipartisan action to change its terms. While the party has campaigned heavily to repeal the act in the past, the law has gained in popularity over recent years, and is now supported by more Americans than oppose it," a 12/16 *FT* [article](#) reported.

President Trump has called for Congress to pass a new health care law that would protect those with pre-existing conditions. Republican Senator Susan Collins wants to see the ACA's requirement to purchase health care struck down even though Congress has eliminated the penalty for failing to take out insurance. Meanwhile, some Democrats would like the law strengthened and turned into Medicare for all.

(2) *From best to worst*. The ACA has been a boon for health care companies as more patients had health insurance, sought care, and could pay for the care they received. In the wake of the judge's ruling, the S&P 500 Health Care sector's stock price index tumbled 6.2%. The sector was dragged down by many of its industries, including Health Care Distributors (-9.0%), Health Care Facilities (-8.4), Pharmaceuticals (-7.5), and Managed Health Care (-7.5) ([Fig. 3](#)). They were each among the worst-performing industries we track.

The S&P 500 Health Care sector contains numerous industries with above-market earnings growth expected for 2019, but they also have above-market forward P/Es. Here are the Health Care industries expected to see faster earnings growth next year than the 8.1% forecasted for the S&P 500 as a whole, along with their 2019 earnings growth forecasts and forward P/Es: Managed Health Care (14.0%, 17.1), Life Sciences (11.3, 23.8), Technology (9.2, 20.9), Health Care Equipment (9.2, 22.1), and Health Care Supplies (9.0, 24.8). The sector's forward P/E of 15.7 is dragged down by the Pharmaceuticals industry, which has a forward P/E of 15.6. Pharmaceuticals is expected to grow earnings by 3.4% in

2019 versus the sector's 7.1% expected earnings growth ([Fig. 4](#) and [Fig. 5](#)).

Consumer Staples: Wounded by the Courts, II. Despite its involvement with all things health related, CVS Health is actually a member of the S&P 500 Drug Retail industry, which is part of the Consumer Staples sector. It too took one on the chin after a federal judge's ruling.

US District Judge Richard Leon questioned the Justice Department's decision to allow CVS Health's acquisition of Aetna. The federal judge noted that the American Medical Association objected to the merger, stating it would substantially reduce competition in health care to the detriment of patients.

Judge Leon initially threatened to halt the integration of the two companies while he considers the deal's implications, a 12/3 *WSJ* [article](#) reported. The decision was highly unusual because judges typically rubber-stamp agreements between the Justice Department and two companies involved in a deal.

This week, CVS offered to maintain control over the pricing of its products and services for its insurance customers and said the two companies wouldn't exchange competitively sensitive information, a 12/18 *WSJ* [article](#) reported. The federal judge agreed to CVS's offer and suggested bringing in an outside monitor to ensure that the offer was upheld. His review of the acquisition could take "at least several months." Ironically, this is the same judge that stopped the Department of Justice from preventing the merger of AT&T and Time Warner.

CVS shares are down 13.3% since the judge's first ruling on 12/3. The stock's performance has weighed on the S&P 500 Drug Retail stock price index, which is down 10.9% so far in December and up 6.9% ytd ([Fig. 6](#)). The S&P 500 Drug Retail industry, which also includes Walgreens Boots Alliance, is expected to grow revenues by 4.6% and earnings by 8.6% in 2019 ([Fig. 7](#) and [Fig. 8](#)). The industry's forward P/E at 12.3 is near the low end of its two-decade range ([Fig. 9](#)).

Technology: Autonomous Vehicles Hitting the Streets. Driverless cars and trucks are inching closer to reality, with numerous test programs occurring in various countries around the world. Here's a quick look at the latest at home and abroad:

(1) *AVs delivering groceries.* Kroger has started using unmanned autonomous vehicles to deliver groceries in Scottsdale, Arizona. The company is working with Nuro's R1, a custom unmanned vehicle that uses public roads and will only transport goods, a 12/18 Reuters [article](#) reports. Kroger's Fry's Food Stores will offer the service for \$5.95 with no minimum order requirement for same-day or next-day deliveries.

(2) *Honking at no one.* According to an 8/28 [article](#) in The Information, Waymo's autonomous cars in Chandler, Arizona are annoying fellow drivers. "More than a dozen local residents who frequently encounter one of the hundreds of Waymo test vehicles circulating in the area complained about sudden moves or stops. The company's safety drivers—individuals who sit in the driver's seat—regularly have to take control of the wheel to avoid a collision or potentially unsafe situation," the article reported.

The vans were reportedly having trouble crossing a T-intersection, making unprotected left turns, and merging into heavy traffic, especially on highways. Sometimes the vans don't understand features like metered red and green lights that regulate cars merging onto freeways. And they are challenged by humans who don't follow traffic laws. That said, Waymo's autonomous vehicles are considered to be ahead of the competition.

(3) *Swedes in the fast lane.* Einride, a startup company, has an electric, autonomous truck driving on a

commercial route between warehouses in the southern Swedish city of Jönköping, reports a 11/5 [article](#) in *Wired*. The truck, with no cab and no human driver, covers about six miles a day at speeds below 25 miles per hour. An Einride employee in a call-center-like facility can drive the truck remotely if a problem occurs.

(4) *Honda goes AV*. Honda Motor is developing an Autonomous Work Vehicle, according to a 12/13 [article](#) on Trucks.com. The vehicle can be used for landscape and agriculture tasks. It has been used to carry supplies and equipment to firefighters and then can trail behind the firefighters in “follow-me” mode. The vehicle has also been used on a farm, where workers load it with produce that the vehicle drives to an area for unloading.

(5) *Hello, Vera*. Volvo’s Vera looks like a sporty car that’s connected wirelessly to a remote transport control center, which would have operators to monitor Vera’s location. Vera can be attached to existing truck trailers, thereby limiting the need to build new systems. Volvo hopes Vera will operate in restricted areas, like ports or warehouse districts, “to carry big loads along fixed routes,” reports a 9/13 [article](#) on Trucks.com.

(6) *Plug in and go*. Anthony Levandowski, the engineer named in the trade-secret lawsuit against Uber by Waymo, has a new company, Pronto AI, that has developed Copilot. It’s a \$4,999 driver-assistance-system kit for long-haul trucks driving on the highway.

“Levandowski said the Pronto system—which he tested with a hands-off, 3,100-mile cross-country drive of his own Toyota Prius sedan in October—uses predictive software paired with an array of six cameras. The cameras send images of the road to a pair of computerized ‘neural networks’ that analyze the images and makes instantaneous decisions regarding steering, acceleration and braking. Neural networks function much like the human brain, learning from the information they take in and continually updating their responses in reaction to new information,” according to a 12/18 [article](#) on Trucks.com. “Levandowski says the system is faster, more accurate and more responsive than the radar and lidar-based technology on which most autonomous driving systems are based.” That said, driving on the highway is the easy part. Driving on side roads in populated areas is far more difficult.

Looks like a drag race among autonomous driving systems is shaping up.

Industrials: Shifting Production. Rising wages and higher taxes have been pushing some manufacturing jobs out of China and into less expensive Southeast Asian countries for awhile. But the shifts may be accelerating due to US tariffs on goods imported from China and the weak yuan. Those manufacturers who remain in the country are increasing the automation in their factories and producing higher-end, more complex products.

Samsung Electronics plans to close a Chinese smartphone factory by year-end and shift production to India, a 12/13 *WSJ* [article](#) reported. It attributed the move to China’s rising labor costs and global trade uncertainties. The move affects about 2,000 Samsung employees in a factory that produces about a third of the company’s China-made phones. Samsung continues to operate another handset factory in southern China as well as factories that produce other items, like batteries and memory chips.

“Between 50% and 60% of the roughly 300 million Samsung handsets shipped annually are assembled in Vietnam, 20% to 30% in China and 10% in India, according to a July report by Simon Woo of Bank of America Merrill Lynch. Following the expansion of the India facility, the percentage of Samsung phones made in China could eventually drop to about 10%,” the *WSJ* article stated.

Smaller manufacturers are also on the move. A 9/21 [article](#) in the *South China Morning Post* tells of Xie

Xusheng, who laid off 160 workers in his processing factory in southern China after opening a new factory in Vietnam's Ho Chi Minh City earlier this year. It makes shoes, bags, and accessories for American brands. Only 40 senior skilled workers remain in the Chinese plant for complicated sample development.

"Small businesses are increasingly struggling with shrinking foreign orders due to US tariffs, a depreciating yuan that raises the cost of imported materials and soaring domestic costs for energy, taxes, rent and labour," the article stated. "This year, the number of lay-offs at small and medium-sized manufacturing firms, tech start-ups and financial organizations has grown at a double-digit rate in percentage terms, according to industry analysts. The situation threatens to get worse, given the escalating trade war with the US."

"The Global Manufacturing Industry is Moving Out of China" is the title of a 10/19 [article](#) in *The Epoch Times*, a New York City-based newspaper founded by a group of Chinese Americans with a focus on news about China and human rights issues. It states that over the past decade, China's manufacturing wages have tripled as taxes, energy prices, and exchange rates have increased.

"China's average direct production cost in 2004 was 6 percent lower than Mexico's, but by 2014, Mexico's production cost was 4 percent lower than China's ... The current average manufacturing cost in China is only about 5 percent lower than in the United States," according to a Boston Consulting Group report cited in the article.

The article notes that Taiwanese factories in China that manufacture shoes for Nike, Adidas, Under Armour, and other brands have moved their production lines to Southeast Asia and India and "Kerry Logistics Network Ltd, Asia's largest shipping and logistics company based in Hong Kong, is currently moving its production lines from China to Malaysia, Vietnam, Myanmar and even Laos."

The march of progress continues, with a little extra push from US tariffs.

CALENDARS

US. Thurs: Leading Indicators 0.0%, Jobless Claims 220k, Philadelphia Fed Manufacturing Index 16.5, EIA Natural Gas Report. **Fri:** Real GDP & PCE (saar) 3.5%/3.6%, GDP Price Index 1.7%, Corporate Profits, Durable Goods Orders Total, Ex Transportation, and Core Capital Goods 1.5%/0.3%/0.3%, Personal Income & Consumption 0.3%/0.3%, Total & Core PCED 1.8%/1.9% y/y, Consumer Sentiment Index 97.5, Kansas City Fed Manufacturing Index, Baker-Hughes Rig Count. (Econoday estimates)

Global. 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. **Fri:** Eurozone Consumer Confidence -4.3, Germany Gfk Consumer Confidence 10.3, France GDP 0.4%q/q/1.4%y/y, UK GDP 0.6%q/q/1.5%y/y, UK Gfk -14, Canada GDP 0.2%m/m/2.2%y/y. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators ([link](#)): Our Bull/Bear Ratio (BBR) fell back below 2.00 this week, bouncing around that level in recent weeks. The BBR sank to 1.84 this week—the lowest reading since early November 2016—after climbing from 1.86 to 2.23 the previous two weeks. Bullish sentiment declined for the second week, from 46.7% to 39.3% over the period, back near its recent low of 38.3% three weeks ago—which was the lowest percentage since late May 2016. It was as high as 61.8% 11 weeks ago. Bearish sentiment rose from 20.4% to 21.4% this week—back near its reading of 21.5% two

weeks ago, which was the highest since November 2016. The correction count and bullish sentiment both are now at 39.3%, with the latter down from 41.1% three weeks ago—which was the highest percentage since late September 2015. The AAI Ratio tumbled to 30.0% last week, after increasing the prior two weeks from 34.9% to 55.4%, as bullish sentiment dropped from 37.9% to 20.9% and bearish sentiment climbed from 30.5% to 48.9%.

S&P 500 Earnings, Revenues, Valuation & Margins ([link](#)): Consensus S&P 500 forward revenues and earnings forecasts both fell last week. Forward revenues is now 0.3% below its record high at the end of November, and forward earnings is down 0.4% from its record high a week earlier. Analysts expect forward revenues growth of 5.7% and forward earnings growth of 8.4%, compared to 5.8% and 8.6% a week ago. Forward revenues growth is down from an 80-month high of 6.3% at the end of February to the lowest level since mid-January, and forward earnings growth is down from a six-year high of 16.9% in February to the lowest level since June 2016. Prior to the passage of the Tax Cuts and Jobs Act (TCJA), forward revenues growth was 5.5% and forward earnings growth was 11.1%. Turning to the annual revenues growth expectations, forecasts were steady w/w at 8.8% for 2018, but down to 5.6% for 2019 from 5.8% a week earlier. The annual earnings growth forecasts, however, moved lower for both years—to 23.8% from 24.0% for 2018 and to 8.1% from 8.3% for 2019. The forward profit margin remained steady at 12.3%, but that's 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 dropped to 6.0% from 6.2%, but forward earnings growth fell 0.2ppt to 8.1%. The S&P 500 ex-Financials forward profit margin remained steady w/w at 11.4%. That's down from a record high of 11.5% in mid-September, but still up from 10.4% before the TCJA. As the market fell last week, valuations dropped to multi-year lows. The S&P 500's forward P/E of 15.3 is the lowest since February 2016, and down 18% from a 16-year high of 18.6 at the market's valuation peak in late January. The S&P 500 price-to-sales ratio of 1.88 is the lowest since February 2017 and down 13% from a record high of 2.16 in late January.

S&P 500 Sectors Earnings, Revenues, Valuation & Margins ([link](#)): Consensus forward revenues rose w/w for five of the 11 sectors, but forward earnings rose for only two sectors. Communication Services was the only sector to have both measures rise w/w. 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 had about tripled from the 18-year low in April 2016 through early November, but has tumbled 7.4% since then. Forward P/S and P/E ratios are now well below their 2018 highs for all sectors, and are at multi-year lows for five sectors: Energy, Financials, Industrials, Materials, and Tech. 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. 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. The outlook for 2019 shows lower y/y margins are expected for 3/11 sectors: Communication Services, Health Care, and Real Estate. During the latest week, the forward profit margin remained steady for all 11 sectors, but 9/11 are down from their cyclical or record highs just a few months ago. Here's how the sectors rank based on their current forward profit margin forecasts versus their highs during 2018: Information Technology (22.8%, down from 23.0%), Financials (at a 2018 high of 19.2), Real Estate (15.4, down from 17.0), Communication Services (14.8, down from 15.4), Utilities (at a 2018 high of 12.8), S&P 500 (12.3, down from 12.4), Materials (11.0, down from 11.6), Health Care (10.6, down from 11.2), Industrials (10.2, down from 10.3), Energy (7.8, down from 8.0), Consumer Staples (7.6, down from 7.7), and Consumer Discretionary (7.5, down from 8.3).

US ECONOMIC INDICATORS

Existing Home Sales ([link](#)): “The market conditions in November were mixed, with good signs of stabilizing home sales compared to recent months, though down significantly from one year ago. Rising inventory is clearly taming home price appreciation,” said Lawrence Yun, the National Association of Realtors’ chief economist. Existing-home sales rebounded 3.3% during the two months ending November to 5.32mu (saar), after a six-month slide of -8.0%. Sales were -7.0% below a year ago. Regionally, sales rose in three of the four regions last month, though were below a year ago in all four. Sales in the Northeast (7.2%m/m & -2.6%/y/y), Midwest (5.5 & -4.3), and South (2.3 & -5.6) showed some signs of life last month, while the West (-6.3 & -15.4) remained the weakest region by far. “A marked shift is occurring in the West region, with much lower sales and very soft price growth,” said Yun. “It is also the West region where consumers have expressed the weakest sentiment about home buying, largely due to lack of affordable housing inventory.” November single-family sales climbed 2.8% over the two-month period to a three-month high of 4.71mu (saar), while multi-family sales climbed 7.0% to a five-month high of 610,000 units. The number of existing single-family homes on the market at the end of October slipped to 1.53mu, 4.1% above a year ago. Unsold inventory is at a 3.9-months’ supply at the current sales pace, falling from its recent high of 4.3 recorded from June through September. The median existing single-family home price was \$260,500 in November, up 5.0% from November 2017.

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