



MORNING BRIEFING

February 14, 2019

Techlash

The next Morning Briefing will be sent on Tuesday, February 19.

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

(1) 2015 all over again? (2) 2018 was a banner year for earnings and impossible to beat this year. (3) Earnings growth recession possible this year. (4) So why are stock prices rallying when everyone is cutting earnings estimates? (5) Those forecasting an earnings recession are also predicting test of Xmas Eve low. (6) All we are saying is: Give 3100 a chance, again. (7) Trump's tax cut was worth \$20 per share. (8) Tech companies have a privacy issue. (9) Internet Bill of Rights. (10) Don't get Zucked! (11) Information Fiduciaries. (12) Will 5G fry our brains?

Strategy: Earnings Recession Score. Joe and I curbed our enthusiasm for the 2019 earnings outlook back at the end of October. Since then, industry analysts have been doing the same. Now a few investment strategists are warning that there will be an earnings recession in 2019, similar to what occurred during 2015.

We cut our S&P 500 earnings growth outlook for this year from the high to the low-single-digit percentages because earnings were so strong last year thanks to Trump's corporate tax cut and better-than-expected revenues growth. The S&P 500 profit margin soared last year to a new record high during Q3. We figured that it isn't likely to move still higher this year and that revenues growth was bound to slow along with the global economy.

Now we are thinking of dropping our outlook for earnings growth closer to zero. So technically speaking, a "growth recession" in earnings is possible this year. We don't expect an outright recession for earnings. We are waiting for the Q4-2018 earnings reporting season to finish before making up our minds on whether to lower 2019 expectations.

So why are stock prices continuing to rebound from last year's Christmas Eve low now that everyone is curbing their enthusiasm for earnings—with some alarmists predicting that that low will be tested once companies confirm how bad earnings are this year? Good question. Why are we still aiming for 3100 on the S&P 500 by year-end? We've previously acknowledged that was our forecast for year-end 2018.

We feel like investors were robbed of a good year. Earnings rose about 24% last year, but the S&P 500 index fell 6.2%. So there should be some catch-up this year even if earnings are flat now that fears of an economic recession have dissipated. Here are some of our related thoughts on this matter:

(1) *Annual earnings and the tax cut.* Earnings per share rose roughly 24%, or by \$31, from \$132 during 2017 to an estimated \$163 during 2018 ([Fig. 1](#)). We estimate that revenues increased 8% over this same period, implying that the profit margin jumped 16%. So \$11 of the earnings gain was from revenues growth and \$20 was from the tax cut, assuming no other factors boosted the profit margin.

The tax cut provides a permanent boost to the profit margin and earnings, assuming it's not rescinded. Other factors (like the dollar, the price of oil, labor costs, and productivity) may or may not depress or boost the profit margin this year. If it remains flat, revenues growth will determine earnings growth.

(2) *Earnings growth rates getting chopped.* Analysts' consensus expected S&P 500 revenues growth rates are holding up reasonably well at 5.1% for this year and 5.4% next year ([Fig. 2](#)). On the other hand, their earnings estimate for this year has plunged from 7.6% at the end of 2018 to 4.6% during the 2/7 week ([Fig. 3](#)). On the other hand, their 2020 estimate is up from 10.8% to 11.2% over the same period.

In our opinion, the market is looking forward to better earnings growth next year and also back to earnings in 2018, which were boosted permanently by the tax cut but not reflected in last year's share price performance.

(3) *Quarterly earnings and the hook.* More often than not, industry analysts tend to lower their earnings estimates too much in the weeks before earnings seasons. The ensuing earnings surprise creates an upward hook pattern on a chart of expected and actual results. In our opinion, analysts are doing it again, turning too pessimistic about the Q1 earnings to be reported mostly during April. Their y/y growth estimate has plunged from 5.5% at the end of last year to 0.1% during the 2/7 week ([Fig. 4](#))

Technology: Privacy Issue. It's been a tumultuous year for Facebook and its customers. Revelations that the Russian government spread fake news on the site were followed by a breach that exposed the data of millions of Facebook accounts. These and similar incidents have sounded alarms about the lack of personal data privacy on the Internet. The growing backlash against the large technology companies ("techlash") has prompted some powerful folks to propose solutions. Among them: presidential candidate Senator Amy Klobuchar (D-MN), Apple CEO Tim Cook, and Silicon Valley venture capitalist Roger McNamee. Here's a look at what each of these advocates is saying:

(1) *DC's politicians getting set to regulate.* Consumer privacy has become a hot topic inside the Beltway. Most recently, Senator Klobuchar made Internet privacy a key issue when announcing her campaign for the presidency on Sunday. "We need to put some digital rules of the road into law when it comes to privacy," she said per a 2/11 *Washington Post* [article](#). "For too long the big tech companies have been telling you: 'Don't worry! We've got your back!' while your identities in fact are being stolen and your data is mined."

Senator Klobuchar isn't alone. House Speaker Nancy Pelosi (D-CA) suggested a new agency be created to manage tech's growing impact, according to a 10/4 *NYT* [opinion](#) piece by Kara Swisher. "'Something needs to be done,' she told [Swisher], to 'protect the privacy of the American people' and 'come up with overarching values'—a set of principles that everyone can agree on and adhere to.'" At Pelosi's request, Representative Ro Khanna (D-CA) compiled an [Internet Bill of Rights](#), comprising 10 principles. Among them are the rights of individuals to opt into data collection and sharing (instead of having to opt out if they don't consent); "to obtain, correct, or delete personal data controlled by any company"; to receive timely notification of data breaches; and to move one's data.

Additionally, the US Government Accountability Office published a [report](#) Tuesday recommending that Congress develop "comprehensive legislation on Internet privacy that would enhance consumer protections and provide flexibility to address a rapidly evolving Internet environment."

(2) *Cook wants legislation.* Apple CEO Tim Cook has broken ranks with the other Tech Kings by supporting federal privacy rules. He published four rights he believes should guide legislation in a recent *Time* [essay](#). He also attacks data brokers to whom personal data are sold, saying these

companies “collect your information, package it and sell it to yet another buyer ... Right now, all of these secondary markets for your information exist in a shadow economy that's largely unchecked—out of sight of consumers, regulators and lawmakers.” Cook’s solution: Have the Federal Trade Commission establish a data-broker clearinghouse that registers all data brokers, lets consumers track their data, and gives consumers the power to delete their data “on demand, freely, easily and online, once and for all.”

(3) *Avoiding getting Zucked.* Privacy is among the key issues raised in *Zucked* by Roger McNamee, a self-described early mentor to Facebook CEO Mark Zuckerberg and an investor in the company. The book details how McNamee came to realize the privacy problems with Facebook, how its leadership failed to act, and how to solve some of the issues.

In a 2/11 [podcast](#) with Recode’s Kara Swisher, McNamee notes that privacy is of increasing importance as the Internet of Things goes mainstream. Consumers will need to ask themselves if they’re okay with the collection of data by “smart” devices—in every room of the house. “I don’t think this notion that people can collect data anywhere, buy data anywhere, and merge it and use it with impunity [...] makes sense,” he told Swisher. McNamee believes it should not be legal to sell people’s location data, most credit card data, or any data about children—but all of that is routinely done.

(4) *Trailing Europe.* The US is far behind Europe, which enacted privacy regulations last year called the “General Data Protection Regulation” (GDPR). A 5/6 *NYT* [article](#) explained: “The new law requires companies to be transparent about how your data is handled, and to get your permission before starting to use it. It raises the legal bar that businesses must clear to target ads based on personal information like your relationship status, job or education, or your use of websites and apps.” The GDPR bestows privacy rights on individuals. It also establishes a national data protection regulator to investigate reported misdeeds and fine offending companies up to 4% of global revenue if they break the law.

Now that privacy is protected, protecting the press is next on the agenda. Published Tuesday, the UK government-commissioned [The Cairncross Review](#) suggests “codes of conduct to govern commercial relationships between the Silicon Valley giants and news publishers that would be overseen by a regulator with enforcement powers,” a 2/13 Bloomberg [article](#) reported. Internet giants are urged to share more of their ad income, and European regulators have proposed a copyright law to “give publishers the right to demand more money from the web platforms. Google has said it might withdraw its news service from the continent as a result.” The report also suggested an investigation of the online ad market; value-added tax relief for online news; charity or other relief for public interest news; creation of a public institution to fund local and investigative reporting; and subsidies to sustain local and public-interest journalism.

(5) *What the legal eagles are saying.* Yale law professor Jack Balkin has suggested a new legal category for Internet companies: Information Fiduciary. As fiduciaries, the companies would have the duties of care, confidentiality, and loyalty to customers much as doctors have to patients, an 11/16 [article](#) in *Slate* explained. Companies would be forbidden to use data in ways that hurt users’ interests, and they might even need to buy malpractice insurance. A fiduciary relationship might make it more difficult for the government to seize our information from Internet providers.

Communication Services: 5G Debate. Timing is a funny thing. On Monday, Verizon launched a website urging consumers to tell their local leaders to support the rollout of 5G. That night, Jackie attended a local meeting of individuals fighting the rollout of 5G. Here’s a quick look at what both sides are saying:

(1) *Verizon's getting political.* Verizon's new website [Lets5g.com](https://lets5g.com) wants individuals to tell their representatives that they support the following statement: "I support the immediate rollout of 5G wireless service in our community because of the benefits it will deliver today and the breakthroughs it will enable tomorrow." According to Lets5g.com, potential benefits of 5G include much faster data speeds, low latency (data-transfer lag time), larger network capacity, and the potential evolution of "smart cities"—featuring connected traffic lights to improve traffic flows and smart, more energy-efficient buildings.

Regarding health concerns, the site says: "All equipment used for 5G must comply with federal safety standards. Those standards have wide safety margins and are designed to protect everyone, including children. Everyday exposure to the radio frequency energy from 5G small cells will be well within those safety limits and is comparable to exposure from products such as baby monitors, Wi-Fi routers, and Bluetooth devices."

(2) *Unhappy consumers.* Those health concerns were front and center at a meeting co-sponsored by "Citizens for 5G Awareness" in Huntington, New York, where the film "Generation Zapped" was shown. The film argues that wireless technology poses health risks, including cancer. The movie portrays the telecom industry as about as trustworthy as Big Tobacco. And it paints regulators as toothless organizations in the pocket of lobbyists.

Concerns about wireless technology are growing as 5G antennas pop up on telephone poles near homes. Fears range from whether wireless signals cause cancer to whether unsightly antennas will decrease property values. The movie portrays regulatory standards as old and feckless. At the very least, Citizens for 5G Awareness would like to see more research on 5G's health impacts done by independent organizations with no stakes in the outcome—i.e., outside of the telecom industry—and done before the 5G rollout occurs. They too are pushing citizens to reach out to their representatives.

The concerns aren't limited to the Huntington objectors, according to a 9/13 *WSJ* [article](#) titled "Across the U.S., 5G Runs Into Local Resistance."

(3) *FCC helping the rollout.* Any pushback from citizens was made more difficult last fall when the Federal Communications Commission (FCC) limited what local governments can charge telecom companies for installing 5G antennas on public property and established a time limit during which 5G applications can be reviewed.

Proponents considered the ruling key to cutting red tape and streamlining the rollout of 5G. "Today, the FCC took the next step to further strengthen the United States' lead in the race to 5G by adopting a framework for permitting and fees that will foster more widespread and robust infrastructure investment," said an AT&T executive quoted in a 9/26 *WSJ* [article](#). Critics viewed the order as federal overreach. A dissenting FCC commissioner was quoted as saying: "I do not believe the law permits Washington to run roughshod over state and local authority like this and I worry the litigation that follows will only slow our 5G future."

No doubt this is a debate that will rage on.

CALENDARS

US. Thurs: Retail Sales Total, Less Autos, Less Autos & Gas, and Control Group 0.1%/0.0%/0.4%/0.4%, Business Inventories 0.2%, Jobless Claims 225k, PPI-FD Total, Core, and Core Less Trade Services 0.2%/0.2%/0.2%, EIA Natural Gas Report, Harker. **Fri:** Headline & Manufacturing Industrial Production 0.1%/0.2%, Capacity Utilization 78.8%, Empire State Manufacturing Index 7.6,

Consumer Sentiment Index 93.0, Import & Export Prices 0.0%/0.1%, Baker-Hughes Rig Count. (Econoday estimates)

Global. Thurs: Eurozone GDP 0.2%q/q/1.2%y/y, Eurozone Employment, Germany GDP 0.1%q/q/0.8%y/y, China Trade Balance \$32.0b. **Fri:** European Car Registrations, Eurozone Trade Balance €16.3b, UK Retail Sales Excluding & Including Fuel 3.1%/3.4% y/y, Japan Industrial Production, China CPI. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators ([link](#)): The Bull/Bear Ratio (BBR) this week ticked down to 2.30, after climbing the prior five weeks from 0.86 (which was the lowest since mid-February 2016) to 2.36. The BBR's bullish sentiment component rose for the sixth straight week, by 19.6ppts, to a 15-week high of 49.5% from 29.9%—which was the fewest bulls since February 2016; bullish sentiment was as high as 61.8% in early October. Meanwhile, bearish sentiment rose to 21.5% this week after falling 14.0ppts the prior five weeks to 20.6% from 34.6%—which was the most bears since March 2016. The correction count fell for the second week, from 33.6% to 29.0%—the lowest since early October; it was at 41.1% 10 weeks ago—which was the highest percentage since late September 2015. The AAll Ratio jumped to a four-month high of 63.6% last week from 50.0% the prior week. Bullish sentiment rose from 31.8% to 39.9% last week, while bearish sentiment moved lower for the third week from 36.3% to 22.8% over the period.

S&P 500 Earnings, Revenues, Valuation & Margins ([link](#)): Consensus S&P 500 forward revenues and earnings forecasts both moved higher for the first time in five weeks. Forward revenues rose 0.2% w/w and is now down 1.0% from a record high in early January. Forward earnings is now 2.1% below its record high in early December after rising 0.6% w/w. Analysts expect forward revenues growth of 5.2% and forward earnings growth of 6.2%, little changed from week-earlier readings of 5.3% and 6.1%, respectively. Forward revenues growth is down from a seven-year high of 6.3% in February 2018 to an 18-month low, and forward earnings growth is down from a six-year high of 16.9% last February and around a 33-month low. 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 growth expectations, analysts expect revenues growth to slow from 8.7% in 2018 to 5.1% in 2019 and 5.4% in 2020. They're calling for earnings growth to slow sharply from 24.0% in 2018 to 4.6% in 2019 before improving to 11.2% in 2020. The forward profit margin remained steady w/w at a nine-month low of 12.1%, and is down 0.3ppt 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's forward P/E rose to a 13-week high of 16.0 from 15.8. That's up from 14.3 during December, which was the lowest reading since October 2013 and down 23% 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 1.94 is up from 1.91 a week earlier and 1.75 during December, which was the lowest since November 2016 and down 19% 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 nine of the 11 sectors, and forward earnings rose for 10 sectors. It was only for Materials that both measures fell w/w; in addition, Energy saw its forward revenues drop. Forward revenues and earnings are at or around record highs for 4/11 sectors: Consumer Discretionary, Health Care, Industrials, and Tech. The forward profit margin appears to be rolling over from recent highs for all but Financials and Utilities. They were at record highs during 2018 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 23.6% since then. Forward P/S and P/E ratios are now well below their 2018 highs for all sectors, and had been at multi-year lows during December for five

sectors: Energy, Financials, Industrials, Materials, and Tech. Energy's forward P/E of 17.0 is on the rise again as earnings deteriorate. Due to the TCJA, margins rose y/y in 2018 for all sectors but Real Estate, but that sector's earnings includes gains from property sales, which typically are infrequent. The outlook for 2019 shows lower margins are now expected y/y for 6/11 sectors: Communication Services, Energy, Health Care, Information Technology, Materials, and Real Estate. During the latest week, the forward profit margin dropped for Materials and actually edged up for five of the 11 sectors. However, nine sectors are down from 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 (22.2%, down from 23.0%), Financials (18.9, down from 19.2), Real Estate (15.4, down from 17.0), Communication Services (14.8, down from 15.4), Utilities (12.9, down from 13.0), S&P 500 (12.1, down from 12.4), Materials (10.7, down from 11.6), Health Care (10.5, down from 11.2), Industrials (at a record high of 10.3), Energy (6.7, down from 8.0), Consumer Staples (7.5, down from 7.7), and Consumer Discretionary (7.5, down from 8.3).

S&P 500 Q4 Earnings Season Monitor ([link](#)): With over 70% of the S&P 500 companies finished reporting earnings and revenues for Q4-2018, y/y revenue and earnings growth remains strong, but the surprise metrics have weakened relative to Q3's results due to Q4's trading turmoil and slowing growth in China. Of the 351 companies in the S&P 500 that have reported through Tuesday evening, just 72% exceeded industry analysts' earnings estimates. Collectively, the reporters have exceeded forecasts by an average of 3.8% and averaged a y/y earnings gain of 15.2%. If those results hold until the end of the quarter, it would mark the smallest earnings beat since Q4-2016 and the slowest y/y growth since Q3-2017. On the revenue side, just 62% of companies beat their Q4 sales estimates so far, with results coming in 0.9% above forecast and 8.0% higher than a year earlier. That marks the smallest revenue beat since Q1-2017, and revenue growth is the slowest in five quarters. Earnings growth is positive y/y for 74% of companies, vs a higher 87% at the same point in Q3, and Q4 revenues have risen y/y for 76% vs a higher 83% during Q3. Looking at earnings during the same point in the Q3-2018 reporting period, a higher percentage of companies (78%) in the S&P 500 had beaten consensus earnings estimates by a greater 7.0%, and earnings were up a higher 28.1% y/y. With respect to revenues at this point in the Q3 season, a lower 60% had exceeded revenue forecasts by a higher 1.6%, and sales rose a greater 9.5% y/y. Excluding the Financials' sector, the earnings surprise improves to 4.7% from 3.8%, but the revenue beat edges down to 0.8% from 0.9%. With 30% of the companies left to report, the Q4 results are still subject to change. However, the slowdown in revenue and earnings growth from Q3 is readily apparent. Q4-2018 should mark the tenth straight quarter of positive y/y earnings growth and the 11th of positive revenue growth.

US ECONOMIC INDICATORS

CPI ([link](#)): January's core CPI rate held above the Fed's target rate of 2.0% y/y for the 11th straight month, though remained below July's peak rate for the sixth month. In January, core prices rose once again by 2.2% for the third consecutive month, holding below July's 2.4% rate—which was the fastest pace since September 2008. Here's a ranking of the core goods rates, lowest to highest: Medical care commodities (-0.3% y/y), new vehicles (0.0), apparel (0.1), alcoholic beverages (1.8), used cars & trucks (1.6), tobacco & smoking products (3.4)—with only the last one surpassing the total core rate of 2.2%. Here's the same exercise for the core services rates: Airfares (-2.8), physicians' services (0.8), hospital services (2.3), motor vehicle maintenance & repair (2.6), owners' equivalent rent (3.2), rent of primary residence (3.4), and motor vehicle insurance (3.4)—with only the rate for motor vehicle maintenance & repair on an accelerating trend. Core prices in January rose 0.2% for the fifth month, pushing the three-month rate up to 2.6% (saar)—the highest since March 2018—after slowing to a 15-month low of 1.7% in October. The headline CPI rate slowed to 1.6% y/y, the lowest since June 2017 and more than a percentage point below its recent high of 2.9% posted in both June and July—which was the highest since February 2012.

GLOBAL ECONOMIC INDICATORS

Eurozone Industrial Production ([link](#)): December output in the Eurozone contracted for the third time in four months—to its lowest level since March 2017. Industrial production (excluding construction) sank 0.9% in December, after a 1.7% drop in November—which was the biggest monthly decline since February 2016. Output slumped 3.1% over the four-month period—with all the main industrial groupings in the red over the time span, though December data were mixed. Here's a tally: capital goods (-1.5% m/m and -4.4% over the past four months), consumer nondurable goods (-1.5, -3.4), energy (-0.4, -3.2), intermediate goods (0.0, -1.5), and consumer durable goods (0.7, -0.9). December production data are available for the top four Eurozone economies; the top two rose during the month, while three and four fell. German output ticked up 0.2% in December, after a three-month slide of 2.5%, while France's remains in a volatile flat trend, climbing 0.8% in December after a 1.4% loss and a 1.4% gain the previous two months. Output in Italy contracted for the fifth time in six months by 0.8% m/m and 2.9% over the period, while Spain's fell three of the past four months, by 1.4% m/m and 3.3% over the four-month span. Among Eurozone countries for which data are available, the largest decreases in industrial production were registered in Ireland (-13.4%), Malta (-5.2) and the Netherlands (-3.2). The highest increases were observed in Luxembourg (+3.5) and Latvia (+3.3).

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