MORNING BRIEFING
March 5, 2019

Will There Be a Peace Dividend?

See the collection of the individual charts linked below.

(1) Another bout of irrational exuberance? (2) Will there be a peace dividend after trade war ends? (3) Stocks rally despite recession-like readings for M-PMIs in China and Europe. (4) Negative economic surprises. (5) Can old age kill a bull market and an economic expansion? (6) Joe devised an alternative to S&P 500 divisor. (7) Joe's share count confirms that buybacks haven't boosted earnings per share by much. (8) Drilling down to the sectors' share counts. (9) Melissa reports that TCJA may reduce stock compensation.

Video Podcast. In my latest video podcast, Chauncey Gardiner on GDP, "There will be growth in the spring," I review the Q4-2018 data on real GDP and discuss why the economy might continue to cruise along without a recession anytime soon. I can safely predict that spring is coming for the economy. (Watch the video and see what Max, my Cavalier King Charles Spaniel, thinks about GDP.)

Global Economy I: Lacking Exuberance. While there has been a great deal of exuberance in global stock markets so far this year, the same cannot be said about the global economy. This suggests that stocks may be suffering from another bout of irrational exuberance. Then again, stock markets are forward-looking, and they are looking forward to a peaceful and bullish resolution of the China-US trade war soon. Investors are also looking forward to a continuation of the easy monetary policies of the major central banks. The policies of the European Central Bank and Bank of Japan remain ultra-easy. The Fed's rate-hiking is on pause, and the Fed will soon announce that tapering its balance sheet (by letting maturing bonds roll off) will terminate, with lots of bonds remaining on the Fed's books.

But what if there is no peace dividend following the end of the trade war? Investors seem to be saying that even if global economic growth remains weak, that's bullish as long as it doesn't lead to a recession. Relatively slow growth puts a lid on inflation and keeps monetary conditions easy. That increases the likelihood that the global economic expansion will continue for the foreseeable future.

The latest batch of global economic indicators remains lackluster. They suggest that this weakness may not be the result only of recent trade frictions but also perhaps of more structural issues, particularly aging demographic developments in China, Europe, and even the United States. Consider the following:

(1) *Global.* As Debbie reported yesterday, the Global M-PMI tumbled to 50.6 during February, down sharply from December 2017's 54.4 peak (*Fig. 1*). This period coincides with rising trade tensions, so perhaps this index will rebound once Trump settles his tiffs with China and Europe.

The weakness in global manufacturing has been especially pronounced among developed economies, with their aggregate M-PMI dropping from 56.3 last January to 50.4 during February. The M-PMI for emerging economies peaked at the end of 2017 at a relatively low level of 52.1. It dipped below 50.0 this January, for the first time since June 2016, edging up to 50.6 in February. Yet the All Country World ex-US MSCI stock price index is up 9.3% in local currencies and 9.6% in dollars ytd through Friday (*Fig. 2*). The US MSCI is up 12.2% over this same period.

(2) *China.* Among the weakest M-PMIs around the world is the one for China (*Fig. 3*). Its official measure edged down to a three-year low of 49.2 during February, the third reading in a row below 50.0. The new orders component of this index plunged from last year's peak of 53.8 during May to 49.6 in January, though it moved back above 50.0 in February, to 50.6. Yet the China MSCI stock price index is up 16.2% ytd, while the Shanghai-Shenzhen 300 index is up 26.6% (*Fig. 4*).

The rally in Chinese shares isn't just about optimism on the trade front. Last Thursday (2/28), MSCI, the company that compiles some of the world's most closely followed share indexes, quadrupled the amount of Chinese stocks in its key benchmarks this year. According to JPMorgan analysts, that could bring an extra $85 billion into China's stock market.

(3) *Eurozone.* February's M-PMIs for the Eurozone continued the plunge that started early last year. The region's M-PMI peaked during December 2017 at 60.6 and fell to 49.3 last month, contracting for the first time since June 2013 (*Fig. 5*). During February, three of the four major M-PMIs were below 50.0: Germany (47.6), Italy (47.7), and Spain (49.9). France (51.5) remained slightly above the contraction demarcation.

The Eurozone Economic Sentiment Indicator, which is highly correlated with the y/y growth rate in real GDP, fell for the eighth consecutive month to the lowest reading since November 2016 (*Fig. 6*). This suggests that growth isn't likely to pick up from last year's reading of 1.2% anytime soon.

So why is the EMU MSCI up 11.0% in euros and 10.6% in dollars? My friend Philip Saunders, who is co-head of multi-asset at Investec Asset Management in London, provided a very good explanation in a 2/27 CNBC interview. He observed that China's economy is very important for European companies and stock prices: "The extreme weakness of (European) markets last year was connected to the Chinese credit cycle, which now shows signs of turning around." If so, then a resolution of the China-US trade dispute should also be a big positive. Last September when I visited our London accounts, I was told that European companies do about 30% of their business with emerging economies.

(4) *US.* Real GDP increased at a solid pace of 2.6% (saar) during Q4-2018 in the US. While that's weaker than the levels of Q2-2018 (4.2%) and Q3-2018 (3.4), the y/y growth rate was at 3.1%, the highest since Q2-2015 (*Fig. 7*). The latter is our preferred measure for assessing the near-term trend of GDP. On the other hand, the latest batch of economic indicators for Q1-2019 suggests that real GDP is starting off on a weak note. The Citigroup Economic Surprise Index plunged from a recent high of 27.3 to -43.1 yesterday (*Fig. 8*).

Contributing to the recent weakness in this index was February's auto sales, which edged down to 16.6 million units (saar), below the 12-month sum of 17.1 million units (*Fig. 9*). Total construction spending edged down during December, remaining 2.4% below its record high last May (*Fig. 10*).

Debbie and I are rounding up the usual suspects for the recent weakness in the economy. The stock market dive late last year weighed on consumer and business confidence. So did the partial government shutdown. Uncertainty about trade didn't help. Finally, it's been a tough winter around the country. But, as I discuss in the video podcast linked above, spring is coming!

Global Economy II: Dying of Old Age? They say that bull markets don't die of old age. The Fed usually kills them by tightening monetary conditions. They say the same about economic expansions. Booms create the speculative and inflationary excesses that force the Fed to tighten monetary policy, causing busts. It follows, therefore, that a slow economic expansion should also last a long time: No boom, no bust.

It's conceivable that this time is different. If the global economy continues to weaken after a China-US trade deal is done, then we might have to conclude that aging demographic trends around the world are killing economic growth:

(1) *In China,* the geriatric demographic profile has been greatly exacerbated by the government's one-child policy, which we have discussed many times before.

(2) *Europe* also faces a rapidly aging population, with mounting political resistance to immigration as a way to solve this problem.

(3) *The US* allows legal immigration and has plenty of illegal immigrants still entering the country. However, the Baby Boomers are aging and turning into minimalists, while the Millennials are natural-born minimalists.

Buybacks I: S&P Divisor Shortcomings. Following up on yesterday's analysis of buybacks, Joe observes that the S&P 500 divisor is not the best proxy for shares outstanding. It is primarily used to adjust the S&P 500's market cap when calculating the index's price. When a "corporate action" takes place that changes the S&P 500's market cap, the divisor is adjusted so that the event has no effect on the index price. The biggest changes to the divisor occur when companies are added or removed from the index and when a merger or spinoff takes place. Special dividends that reduce a company's market cap, as well as secondary offerings or Dutch tender offers, can also have a big impact, but they occur less frequently.

In all of these cases, S&P adjusts the divisor when the actions occur. The divisor is also adjusted for changes in shares outstanding that can occur from the exercise of compensation-based stock options and share buybacks. That's typically done during quarterly rebalancing.

Since the divisor isn't shares outstanding *per se*, Joe came up with a publication that shows the aggregate basic shares outstanding for the S&P 500 and its sectors. (See our *S&P 500 Shares Outstanding By Sectors Since 2007*.) His measure of share count tracks the divisor closely, but with two exceptions:

(1) S&P's divisor history represents the companies that were in the index at the time the divisor was calculated. Joe's report aggregates the basic shares outstanding for the *current* index members as far back as possible, so it is not affected by index additions and deletions. In this case, he went back to Q1-2007, which covered 95% of the index.

(2) S&P's divisor tracks the market cap of the index, as its purpose is to keep the index's price consistent. Joe's report looks solely at the shares outstanding.

In any event, as we observed yesterday, Joe's share count for the S&P 500 closely tracks the index's divisor (*Fig. 11*). Since the start of the bull market during Q1-2009 through Q3-2018, the divisor is down 2.9%, while the share count is down 1.9%. Both were boosted by the issuance of lots of stock by financial firms during 2009 and 2010. Since Q1-2011, the divisor is down 7.2%, while the share count is down 7.3%.

The conclusion remains that buybacks haven't had a significant impact in boosting earnings per share (*Fig. 12*). We compared the growth rate in S&P 500 per-share and aggregate earnings since the start of the bull market for each year from 2009-2018, and found that the average spread between the former and the latter was only 0.4 percentage point, with a low of -5.6 and a high of 2.8 (*Fig. 13* and *Fig. 14*).

Buybacks II: The Sectors Story. I asked Joe to drill down to the S&P 500's sectors in his share-count analysis. He found that since Q1-2009, the share count fell for just six of the 11 sectors (*Fig. 15*). The increases that occurred did do so because of shares that were issued for acquisitions or mergers. Some big examples of that during 2018 were AT&T's combination with Time Warner and Lennar's marriage with CalAtlantic. Those activities saw the share counts of the surviving entities, AT&T and Lennar, rise about 18% and 30%, respectively.

Some sectors routinely issue new shares as currency for acquisitions, while other, more profitable sectors tend to put more cash on the table. Furthermore, some sectors have run into hard times (Financials and Energy) and recapitalized their balance sheets by issuing shares and diluting existing shareholders.

Joe's data since the start of the bull market in Q1-2009 through Q3-2018 show that the S&P 500's aggregate number of basic shares outstanding has dropped only 1.9%. Here's how the sectors ranked since then: Real Estate (66.8%), Utilities (28.0), Financials (21.6), Materials (13.4), Energy (2.7), Communication Services (-1.4), Consumer Discretionary (-4.8), Health Care (-5.6), Industrials (-12.0), Consumer Staples (-12.8), and Information Technology (-16.7). The story doesn't change much if we start the performance derby during Q1-2011, except that the share count declines for Financials (*Fig. 16*).

Buybacks III: TCJA's Impact on Stock Grants. Yesterday, I observed that it is progressive politicians who are responsible for the proliferation of stock grants, as they passed a law in 1993 that limited the deductibility of an executive's pay above $1 million in cash. President Trump's Tax Cuts and Jobs Act (TCJA), passed in December 2017, once again changed the rules in ways likely to alter the structure of executive compensation—this time reducing stock buybacks.

"The changes are really monumental," Helen Morrison of Ernst & Young (EY) said, according to an 8/28 EY note subtitled "Under the Tax Cuts and Jobs Act, rules governing executive pay have dramatically changed, prompting a possible need to review compensation." I asked our in-house Certified Public Accountant, Melissa, to investigate. Here is her report:

(1) *Original sin*. Following through on campaign proposals to limit executive compensation, President Bill Clinton signed into law the Revenue Reconciliation Act of 1993. IRC 162(m) codified the compensation rules within the Act. The rules limited the deductibility of public company executive compensation to $1 million for the highest level corporate senior executives ("covered employees") with an important exception, namely performance-based pay (including stock options).

Jeffrey Korzenik, the chief investment strategist at Fifth Third Bank and a good friend of Yardeni Research, observed in a 2009 *Forbes* article that these tax rules didn't much impact overall executive compensation, but rather incentivized firms to structure pay in a way that encouraged "short-term thinking and excessive risk-taking." Years later, the US House of Representatives' Ways and Means Committee wrote in a 2017 summary of its tax proposal that the shift away from cash compensation to performance-based pay such as stock options has "led to perverse consequences as some executives focus on … quarterly results (off of which their compensation is determined), rather than on the long-term success of the company," according to EY.

(2) *New commandment*. President Trump's TCJA both lowered the federal statutory corporate tax rate and eliminated lots of corporate deductions (for more, see EY's helpful summary). Critical modifications

were made to the executive compensation deductibility limits under the TCJA. Starting in the tax year 2018, the performance-based pay exception is eliminated (with the grandfathering-in of some preexisting agreements allowed) and the concept of "covered employees" is expanded. The "Modification of limitation on excessive employee remuneration, with transition rule" could bring in an additional $9.2 billion in tax revenue for the federal government over the next decade, according to the Joint Committee on Taxation's estimate.

(3) *Repentance*. In consideration of these monumental changes to the tax deductibility of executive compensation, publicly traded corporations are now evaluating how to best structure executive pay programs going forward. This could provide for more flexibility in pay structure, says Morrison at EY.

Our take is that the new rules may mean fewer stock option awards in the future, which could also mean that fewer share repurchases will be needed to offset their dilutive effect.

CALENDARS

US. Tues: ISM & IHS Markit NM-PMIs 57.2/56.2, New Home Sales 591k, Treasury Budget $0.0b, Rosengren. **Wed:** ADP Employment 180k, Merchandise Trade Balance -$57.6b, MBA Mortgage Applications, EIA Petroleum Status Report, Beige Book, Williams, Mester. (Econoday estimates)

Global. Tues: Eurozone Retail Sales 1.3%m/m/2.1%y/y, Eurozone, Germany, France, and Italy C-PMIs 51.4/52.7/49.9/48.6, Eurozone, Germany, France, and Italy NM-PMIs 52.3/55.1/49.8/49.5, UK C-PMI & NM-PMI 50.1/50.0, Italy GDP -0.2%q/q/0.1%y/y, Japan C-PMI & NM-PMI, China Caixin NM-PMI 53.5, RBA Cash Rate Target 1.50%, Carney, Lowe. **Wed:** Australia GDP -.5%q/q/2.7%y/y, BOC Rate Decision 1.75%, OECD Interim Economic Outlook. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose w/w for LargeCap, but fell for MidCap and SmallCap. All three of these indexes are still on the downtrend that began in late October. LargeCap's forward EPS is now 2.2% below its record high of $175.48 in late October, while MidCap's and SmallCap's are now 2.7% and 6.9% below their mid-October highs, respectively. LargeCap's forward EPS is the most below its record high since June 2016, while MidCap and SmallCap have not been this far below since March 2016 and December 2010, respectively. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act, but is tumbling now as y/y comparisons become more difficult. In the latest week, the rate of change in LargeCap's forward earnings fell to a 25-month low of 6.8% y/y from 6.9%. That's down from 23.2% in mid-September, which was the highest since January 2011 and compares to a six-year low of -1.8% in October 2015. MidCap's y/y change was down to a 25-month low of 7.9% from 8.3%, which compares to 24.1% in mid-September (the highest since April 2011) and a six-year low of -1.3% in December 2015. SmallCap's dropped to a 16-month low of 10.1% from 11.5%, which is down from an eight-year high of 35.3% in early October and compares to a six-year low of 0.3% in December 2015. Analysts had been expecting double-digit percentage earnings growth in 2019, but those forecasts have been dropping since October. Here are the latest consensus earnings growth rates for 2018, 2019, and 2020: LargeCap (22.5%, 4.0%, 11.9%), MidCap (23.2, 3.5, 12.2), and SmallCap (21.2, 8.6, 16.7).

S&P 500/400/600 Valuation (*link*): Forward P/E ratios were mostly steady w/w for these indexes, which are up now from multi-year lows in late December. LargeCap and MidCap are at their highest levels since early October, and the SmallCap is the near its highest level since late September. LargeCap's weekly forward P/E of 16.3 was steady w/w and is up from a five-year low of 13.9 during December. That compares to a six-month high of 16.8 in mid-September and a multi-year high of 18.6 on January

26 (highest since May 2002), and of course is well below the tech-bubble record high of 25.7 in July 1999. Last week's level remains above the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's forward P/E of 15.9 was unchanged w/w, but is up from 13.0 during December, which was the lowest reading since November 2011. MidCap's P/E is down from a 15-year high of 19.2 in February 2017 and the record high of 20.6 in January 2002. However, MidCap's P/E has been at or below LargeCap's P/E for most of the time since August 2017—the first time that alignment has prevailed since 2009. SmallCap's P/E edged down w/w to 17.1 from 17.2, but is up from 13.6 during December, which had marked its lowest reading since November 2011. That's well below its 51-week high of 20.2 in December 2017 (which wasn't much below the 15-year high of 20.5 in December 2016, when Energy's earnings were depressed). SmallCap's P/E was higher than LargeCap's P/E for a sixth week, after being below for much of December for the first time since 2003.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): With the Q4 earnings season nearly finished, analysts are essentially done revising their Q1 forecasts. Last week saw the S&P 500's Q1-2019 EPS forecast drop 11 cents w/w to $37.65. That's down 9.0% since the end of Q3. The $37.65 estimate represents a forecasted pro forma earnings decline for Q1-2019 of 1.1%, compared to -0.8% a week earlier and 5.3% at the end of Q4. If it comes to pass, Q1's y/y decline would be its first after 10 straight gains, and down from 16.7% in Q4 and 28.4% in Q3 (which marked the peak of the current earnings cycle). Just four of the 11 sectors are expected to record positive y/y earnings growth in Q1-2019, with none rising at a double-digit percentage rate. That compares to 10 positive during Q4, when six rose at a double-percentage rate. Five sectors are expected to beat the S&P 500's Q1 growth rate, compared to just four during Q4. Utilities is the only sector expected to post better growth on a q/q basis during Q1. Here are the latest forecasted Q1-2019 earnings growth rates versus their blended Q4-2018 growth rates: Industrials (5.5% in Q1-2019 versus 27.2% in Q4-2018), Health Care (5.1, 13.2), Financials (4.0, 15.6), Real Estate (2.4, 6.2), Utilities (-0.3, -10.5), Consumer Staples (-2.3, 4.8), Consumer Discretionary (-2.8, 17.2), Communication Services (-5.3, 26.3), Information Technology (-6.4, 9.9), Materials (-12.7, 4.1), and Energy (-15.0, 81.5). On an ex-Energy basis, analysts expect S&P 500 earnings to drop 0.4% y/y in Q1, well below the 14.0% y/y gain in Q4.

S&P 500 Q4 Earnings Season Monitor (*link*): With over 96% 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 482 companies in the S&P 500 that have reported through mid-day Wednesday, just 70% exceeded industry analysts' earnings estimates. Collectively, the reporters have exceeded forecasts by an average of 3.5% and averaged a y/y earnings gain of 14.3%. These results mark the smallest earnings beat since Q2-2014 and the slowest y/y growth since Q3-2017. On the revenue side, just 60% of companies beat their Q4 sales estimates so far, with results coming in 0.5% above forecast and 5.7% higher than a year earlier. That marks the smallest revenue beat since Q4-2016, and revenue growth is the slowest in five quarters. Earnings growth is positive y/y for 71% of companies, versus a higher 87% at the same point in Q3, and Q4 revenues have risen y/y for 74% versus 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 6.7%, and earnings were up a higher 27.3% y/y. With respect to revenues at this point in the Q3 season, a slightly higher 61% had exceeded revenue forecasts by a higher 1.3%, and sales rose a greater 8.6% y/y. Excluding the Financials sector, the earnings surprise improves to 4.5% from 3.5%, and the revenue beat edges up to 0.7% from 0.5%. With less than 4% of the companies left to report, it's safe to say that Q4-2018 marks the tenth straight quarter of positive y/y earnings growth and the 11th of positive revenue growth, but the slowdown in revenue and earnings growth from Q3 levels is readily apparent.

US ECONOMIC INDICATORS

Construction Spending (*link*): Construction spending unexpectedly fell during the final month of 2018, with growth for the total year the slowest since 2011. Total construction spending contracted 0.6% in December following a two-month gain of 1.0% and a two-month loss of 2.3%—fluctuating in a volatile flat trend below May's record high. Both private and public construction spending ended 2018 on a down note, with the former falling 0.6% in December and the latter 1.6% during the two months ending December. For all of 2018, construction spending rose 4.1%, slowing steadily from 2014's 11.0% pace. Private construction spending expanded at a seven-year low of 3.4%, while public construction spending expanded 6.6%—the best since 2008. Within private construction, residential investment eased to 3.3% after posting double-digit gains for six straight years. Both single-family (5.2%) and home improvement (1.5) spending slowed from double-digit gains in prior years, while multi-family (0.7) building barely budged last year, though was an improvement from 2017's 1.9% decline. Meanwhile, private nonresidential structures increased 3.6% during 2018, more than double 2017's 1.3% though considerably below the average annual gain of 11.5% posted during 2004 through 2016.

Auto Sales (*link*): Motor vehicle sales in February dropped to an 18-month low as domestic car sales sank to their lowest pace since fall 2010. Total sales sank further below 17.0 million units last month, dropping to 16.6mu (saar)—a million units below the 17.6mu pace at the end of 2018. Domestic car sales fell to 3.7mu (saar) from 4.0 million in January and a recent high of 4.8 during September 2017. These sales have been in a virtual freefall since peaking at 6.1mu (saar) during August 2014. Domestic light-truck sales ticked up to 9.2mu (saar) in February, after plunging from 9.8mu in December (which was the highest reading since July 2005, when they were boosted by aggressive discounts) to 9.0mu in January. Sales of imports, at 3.8mu (saar), continue to fluctuate just below last May's peak of 4.0mu—which was the strongest pace since August 2009.

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