



## MORNING BRIEFING

May 22, 2019

### Will Trade Winds Blow Away Earnings?

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

(1) Q1 earnings tick up y/y. (2) Q2 earnings consensus showing y/y downtick. (3) Escalating trade war starting to weigh on revenues? (4) Forward earnings moving higher. (5) Forward profit margin bottoming at 12%? (6) Boom-Bust Barometer drops along with CRB commodity index. (7) Earnings growth momentum due for a rebound. (8) Still expecting a peace dividend by the end of the summer. (9) Our new comprehensive study on buybacks. (10) Counting shares for the S&P 500 since Q1-2011. (11) Powell's unalarming speech on corporate debt.

**Earnings I: Recession Delayed by a Quarter?** The latest earnings season is almost over, with 92% of S&P 500 companies having reported their earnings for Q1. Once again, there was an earnings hook, with results exceeding expectations. Meanwhile, S&P 500 forward revenues has stalled at a record high over the past couple of weeks. Forward earnings is inching back up closer to its record high during the week of 10/26. The forward profit margin may be starting to bottom. Let's have a closer look at the latest data:

(1) *Earnings season.* During the 4/11 week, the consensus of industry analysts was that earnings fell 2.5% y/y. During the 5/16 week, the growth rate was positive, with a reading of 2.4% ([Fig. 1](#) and [Fig. 2](#)).

Nevertheless, the companies and analysts are up to their old tricks as they lower their Q2 estimates, setting the market up for another upside surprise during the next earnings season. At the beginning of this year, the analysts' consensus predicted that Q2 earnings would be up 4.9% y/y. During the 5/16 week, their estimate showed a 0.8% decline for the coming earnings season. However, their latest estimate for Q3 is still slightly positive at 1.7%, while Q4 is solidly positive at 8.4%.

(2) *Forward revenues.* Joe reports that the latest available data for consensus revenues estimates for this year and next year are available through the 5/16 week ([Fig. 3](#)). The trade war between the US and China started to escalate just about then, so it will be interesting to see whether revenue estimates get cut in coming weeks. The initial impact has been a stall in forward revenues since the record high during the 4/4 week. Meanwhile, consensus expected revenues growth is holding up remarkably well, at 5.0% for 2019 and 5.3% for 2020 during the 5/16 week ([Fig. 4](#)). We will find out in coming weeks if the trade war will start to weigh on revenues.

(3) *Forward earnings.* While industry analysts continue to chip away at their S&P 500 earnings estimates for 2019 and 2020, forward earnings has been moving higher in recent weeks, through the 5/16 week, because it is converging toward the 2020 earnings estimate, which exceeds the 2019 estimate by 11.2% currently ([Fig. 5](#) and [Fig. 6](#)).

(4) *Forward profit margin.* It's too soon to be sure, but the forward profit margin—which we calculate by dividing forward earnings by forward revenues—may be starting to bottom around 12.0% ([Fig. 7](#)). This weekly series tends to be a very good coincident indicator of the actual quarterly S&P 500 profit margin,

which was 11.9% during Q4-2018.

(5) *Market targets.* Industry analysts currently estimate that S&P 500 earnings will be \$167 per share this year and \$187 next year, with forward earnings at \$175 per share. To get to our 3100 target for the S&P 500 would require that the forward P/E rise to 18 (since  $\$175 \times 18 = 3,150$ ). We still have plenty of time to get there with a lower forward P/E if forward earnings continues to converge to a lower 2020 estimate, say \$180. Multiplying that number by a forward P/E of 17 yields 3060 on the S&P 500 by the end of this year.

**Earnings II: Looking Forward.** S&P 500 forward earnings is highly correlated with our Boom-Bust Barometer (BBB), which is the ratio of the CRB raw industrials spot price index and initial unemployment claims ([Fig. 8](#)). BBB took a dive during the 5/11 week as commodity prices tumbled because of the escalating US-China trade war. Yet forward earnings has been moving higher in recent weeks.

However, the growth momentum of forward earnings, using the y/y percentage change, remains weak, with an increase of 4.5% during the 5/16 week, the lowest since December 2016 ([Fig. 9](#)). This growth rate is highly correlated with the ISM Manufacturing PMI, which dropped from a recent high of 60.8 last August to 52.8 during April. Forward earnings growth is also highly correlated with the y/y growth in US manufacturing and trade sales ([Fig. 10](#)).

We expect that the growth momentum of forward earnings will improve over the rest of the year through 2020. Much of the recent slowdown reflects tough y/y comparisons since Trump's corporate tax cut boosted 2018 earnings. We are also assuming no recession in the US for the rest of this year and for 2020.

Do we need a peaceful deal to end the US-China trade war? It would certainly help to revive global economic activity. Our assumption is that a deal will happen by the end of the summer and that it will provide a "peace dividend" for the global economy. Obviously, that scenario hasn't been working out so far.

**Buybacks I: New Topical Study.** Joe and I just posted our [Topical Study #84](#), titled "The Truth About Stock Buybacks" on our website. It includes all of our recent research on S&P 500 buybacks. Here are some key excerpts:

(1) "The most common reason that S&P 500 companies buy back their shares is to offset the dilution in the number of shares outstanding that results when employee compensation takes the form of stock options and stock grants that vest over time, not just for top executives but for many employees. In effect, the ultimate source of funds for most stock buybacks is the employee compensation expense item on corporate income statements, not bond issuance as the bears contend."

(2) "To a large extent, the bull market in stocks has been boosting buybacks, rather than the other way around as widely believed. Rising stock prices increase the attractiveness of paying some of employees' compensation with stock grants. Buybacks then are necessary to offset the dilution of earnings per share."

(3) "Stock compensation clearly has boosted the incomes of plenty of corporate executives, but that stems from the bull market in stocks since 2009 more than from buybacks. More importantly, blaming buybacks for widespread income stagnation doesn't make any sense, since the data clearly show that standards of living have been rising in record-high territory for most Americans for several years, contrary to the Progressives' tale of widespread woe."

(4) “It makes no sense to compare the amount that S&P 500 corporations spend on buybacks to their after-tax profits, as is often done! In the NIPA, money spent on buybacks (to cover employee stock plan obligations) doesn’t come out of the after-tax profits pool as dividend payouts and capital outlays do. The contention that money used for buybacks would be better invested in growth of the business is faulty.”

(5) “Since the first quarter of 2011 through the last quarter of 2018, S&P 500 companies repurchased 72 billion shares and issued 50 billion shares, resulting in net repurchases of 22 billion shares. Net issuance (actually, net buybacks in this case) has fluctuated at around a third of gross buybacks from the first quarter of 2011 through the fourth quarter of 2018. That explains why the amount that gross buybacks have contributed to the growth of earnings per share has been relatively small.”

**Buybacks II: Naming Names.** In [Appendix 3a](#) of our *Topical Study*, we show the percent change in the number of basic shares outstanding from Q1-2011 through Q4-2018 for each of the S&P 500 companies. It is sorted by the percent change. We do the same in [Appendix 3b](#), but it is sorted alphabetically. Please have a look.

Plenty of companies certainly have had aggressive buyback programs aimed not only at offsetting dilution from stock compensation but also at boosting earnings per share. However, as demonstrated in our *Topical Study*, the overall impact of buybacks on S&P 500 earnings per share has been relatively small.

**The Fed: Powell’s Happy Spin on Corporate Debt.** Melissa and I can’t recall any speech by any Fed official dedicated to corporate-sector leverage, though plenty have mentioned it in a cursory fashion. But now, the issue has risen in prominence to the point where Fed Chairman Jerome Powell focused on the historic rise in corporate debt in a 5/20 [speech](#) titled: “Business Debt and Our Dynamic Financial System.” It’s a nice break from all of the inflation discussions of late and certainly pertinent to the Fed’s supervisory role over financial stability, particularly in the wake of the financial crisis.

Powell’s key message is that corporate debt is elevated, and borrowers should be monitored for signs of stress, but this should not pose any major systemic risks to the financial system. He stated: “In public discussion of this issue, views seem to range from ‘This is a rerun of the subprime mortgage crisis’ to ‘Nothing to worry about here.’ At the moment, the truth is likely somewhere in the middle.” We like that conclusion because it’s also our own. A lot of the points that Powell raised in his speech were ones we’d made in our 5/15 [Morning Briefing](#) reviewing the Fed’s May 2019 [Financial Stability Report](#). Here’s more on what Powell said:

(1) *Where we are now?* Powell showed that business debt is historically high with a [chart](#) of corporate debt relative to the book value of assets. The ratio is at the “upper end of its range” looking back to 2000. Mitigating his concern about this, however, are the strong business environment and historically low costs of debt-servicing.

(2) *Risky borrowing.* If a downturn were to occur, Powell warned, it could strain the debt markets, especially BBB-rated bonds, i.e., just above non-investment grade. If those bonds fell in rating status, some investors would be required to sell, causing lots of stress in the junk bond market.

Powell also discussed the increase in borrowing by riskier businesses—typically funded by nonbank lenders and representing a mix of high-yield bonds and leveraged loans—and weakened underwriting standards, especially for leveraged loans. Collateralized loan obligations (CLOs)—which collapsed during the financial crisis of 2008—are the largest holder of outstanding leveraged loans at about 62%,

he said. Mutual funds, the next-largest, hold about 20% of the leveraged market. Liquidity could become an issue here, as “these funds allow investors to redeem their shares daily, although the underlying loans take longer to sell.”

But the Fed monitors CLOs and other opaque borrowing structures for soundness. And, Powell said, making a case we’ve made before, structures like CLOs are “much sounder than the structures that were in use during the mortgage credit bubble. ... [T]oday banks at the core of the financial system are fundamentally stronger and more resilient.”

(3) *This time isn’t the same as last time.* The leverage situation today is a far cry from that leading up to the financial crisis, which was caused by excess borrowing in the household sector. Today, the leverage is in the corporate sector, which does not pose comparable risks, especially in today’s environment.

Powell stated: “[T]he parallels to the mortgage boom that led to the Global Financial Crisis are not fully convincing. Most importantly, the financial system today appears strong enough to handle potential business-sector losses, which was manifestly not the case a decade ago with subprime mortgages.” Further, he observed “that the current situation looks typical of business cycles. The mortgage credit boom was, because of its magnitude and speed, far outside historical norms.”

## CALENDARS

**US. Wed:** MBA Mortgage Applications, DOE Crude Oil Inventories, FOMC Meeting Minutes, Williams. **Thurs:** Jobless Claims 215k, New Home Sales 675k M-PMI & NM-PMI Flash Estimates 52.7/53.5, Kansas City Fed Manufacturing Index 7, EIA Natural Gas Report, Kaplan. (DailyFX estimates)

**Global. Wed:** UK Headline & Core CPI 2.2%/1.8% y/y, Canada Retail Sales Total & Ex Auto 1.0%/0.8%, Draghi, Praet. **Thurs:** Eurozone, Germany, and France C-PMI Flash Estimates 51.7/52.0/50.3, Eurozone, Germany, and France M-PMI Flash Estimates 48.1/44.8/50.0, Eurozone, Germany, and France NM-PMI Flash Estimates 53.0/55.4/50.8, Germany GDP 0.4%q/q/0.7%y/y, Germany Ifo Business Climate, Current Assessment, and Expectations Indexes 99.1/103.5/95.0, Japan Headline, Core, and Core-Core CPI 0.9%/0.9%/0.6% y/y, ECB Releases Minutes of April Policy Meeting, European Parliamentary Elections, Guindos. (DailyFX estimates)

## STRATEGY INDICATORS

**S&P 500 Sectors Net Earnings Revisions** ([link](#)): The S&P 500’s NERI was positive in May for the first time in seven months, and improved for a third straight month. The six-month negative NERI streak from November to April followed 18 months of positive readings, which had been its longest positive streak since a 26-month string ending August 2011. NERI rose to 0.8% from -4.4% in April, which compares to a record high of 22.1% in March 2018. NERI improved m/m for all 11 sectors, the first time that has happened since January 2018; that compares to eight improving in April. NERI was positive for 4/11 sectors, compared to negative readings for all 11 sectors from February to April. Consumer Staples has the worst track record, with 13 months of negative NERI, followed by Materials (8) and Communication Services. Here are the sectors’ May NERIs compared with their April readings: Health Care (8.0% in May, up from -0.6% in April), Tech (4.6, -2.2), Energy (4.1 [9-month high], -3.1), Real Estate (0.3, -6.4), Financials (0.0, -7.1), Consumer Discretionary (-0.2, -3.0), Communication Services (-1.4, -4.5), Consumer Staples (-1.6 [13-month high], -6.0), Utilities (-1.6, -3.3 [32-month low]), and Materials (-9.3, -18.3).

**S&P 500 Earnings, Revenues, Valuation & Margins** ([link](#)): Consensus S&P 500 forward revenues

remained near a record high for a seventh week, and forward earnings rose for a fifth week to 0.4% below its record high in early December. Analysts expect forward revenues growth of 5.4% and forward earnings growth of 7.2%. Forward revenues growth is down 0.9ppt from a seven-year high of 6.3% in February 2018, but is up from a 31-month low of 5.0% in mid-February. Forward earnings growth is down 9.7ppts from a six-year high of 16.9% last February, but that's up from a 34-month low of 5.9% in late February. 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 8.3% in 2018 to 5.0% in 2019 and 5.3% in 2020. They're calling for earnings growth to slow sharply from 24.1% in 2018 to 3.4% in 2019 before improving to 11.2% in 2020. The forward profit margin was steady w/w at 12.1%, but 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 has moved higher in 15 of the past 20 weeks and peaked at an eight-month high of 17.0 in late April. It edged down 0.1 point in the latest week to an eight-week low of 16.5. That's up from 14.3 during December, which was the lowest reading since October 2013 and down 23% from the 16-year high of 18.6 at the market's valuation peak in January 2018. The S&P 500 price-to-sales ratio of 1.99 is up from 1.75 during December, when it was the lowest since November 2016, and down 19% from its then-record high of 2.16 in January 2018.

**S&P 500 Sectors Earnings, Revenues, Valuation & Margins** ([link](#)): Consensus forward revenues rose w/w for two of the 11 S&P 500 sectors and forward earnings for 6/11 sectors. Industrials and Real Estate had 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. Energy's forward earnings is beginning to move higher now after tumbling about 25% from November to February. Forward P/S and P/E ratios are now well above their multi-year lows during December 2018 for all sectors, and are near or above their 2018 highs for four sectors: Communication Services, Real Estate, Tech, and Utilities. Due to the TCJA, the profit margin for 2018 was higher y/y for all sectors but Real Estate. The outlook for 2019 shows higher margins are expected y/y for just 4/11 sectors: Consumer Discretionary, Financials, Industrials, and Utilities. The forward profit margin rose to record highs during 2018 for 8/11 sectors, all but Energy, Health Care, and Real Estate. Since then, it has moved lower for nearly all of the sectors, but early signs of a bottom are appearing. During the latest week, the forward profit margin rose 0.3ppt for Real Estate, 0.1ppt for Financials and Utilities, and dropped 0.1ppt for Energy and Materials. 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 (18.7, down from 19.2), Real Estate (15.6, down from 17.0), Communication Services (14.8, down from 15.4), Utilities (13.0, matching its prior record in late January), S&P 500 (12.1, down from 12.4), Health Care (10.5, down from 11.2), Materials (10.3, down from 11.6), Industrials (10.2, down from a record high of 10.4 in mid-March), Consumer Discretionary (7.6, down from 8.3), Consumer Staples (7.4, down from 7.7), and Energy (7.1, down from 8.0).

## US ECONOMIC INDICATORS

**Existing Home Sales** ([link](#)): Existing home sales contracted in April for the second month after posting its biggest gain since December 2015 in February. Existing-home sales—tabulated when a purchase contract closes—dipped 0.4% last month to 5.19mu (saar) after a 4.9% drop in March; February sales had rebounded 11.2% to 5.48mu, which was its best level in nearly a year. Regionally, sales in April rose in the West (1.8% m/m & -5.9% y/y), fell in the Northeast (-4.5 & -4.5), and were flat in the Midwest (0.0 & -7.9) and South (-0.4 & -1.7); they remained below year-ago levels in all the regions. Single-family sales sank 5.9% during the two months through April to 4.62mu (saar) after soaring 12.6% during February; sales were 4.0% below a year ago. Multi-family sales rebounded 5.6% to 570,000 units (saar) after a like decline the month before; these sales were 8.1% below a year ago. Lawrence

Yun, NAR's chief economist, said he is not overly concerned about the recent decline in sales and expects moderate growth very soon. "First, we are seeing historically low mortgage rates combined with a pent-up demand to buy, so buyers will look to take advantage of these conditions," he said. "Also, job creation is improving, causing wage growth to align with home price growth, which helps affordability and will help spur more home sales." Meanwhile, the number of single-family homes on the market at the end of April increased to 1.61 million, jumping 20.1% ytd—"providing more choices for those looking to buy a new home," Yun noted.

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