



MORNING BRIEFING

June 26, 2019

Earnings Season's Greetings

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

(1) Get ready for another quarterly upside hook. (2) S&P 500 forward revenues and earnings per share at record highs. (3) Will macro slowdown show up in micro earnings reports? (4) Consumers are in a good place, though their confidence moderated a bit in June. (5) Are jobs really getting harder to find, or are skill mismatches getting worse? (6) Home sales should get a lift from lower mortgage rates. (7) Business equipment production is mostly down ytd with exception of information processing equipment. (8) Defense output taking off. (9) Mixed picture: trucks vs railroads. (10) Bank loans at record high. (11) Hard to find anything good to say about overseas economies. (12) Two studies with different results about S&P 500's foreign sales exposure.

Earnings I: Industry Analysts Doing It Again. Q2 is coming. Actually, it is almost over, but the earnings reporting season for the quarter will take place mostly during July. Q1 turned out to be better than industry analysts expected. The same is likely for Q2. That's because they tend to get too pessimistic as reporting seasons approach. That often results in an upside earnings hook when all the results are in.

That happened again during Q1, when S&P 500 industry analysts estimated a 2.5% y/y drop for the quarter during the 4/11 week, just as the season started ([Fig. 1](#) and [Fig. 2](#)). They got the magnitude about right, but the sign wrong: Earnings per share (EPS) rose 2.8%.

Now during the 6/20 week, they are estimating a 1.3% drop in EPS. They've lowered their EPS estimate for the quarter by 6.0% since the start of the year.

So why is the S&P 500 in record-high territory? Despite the analysts' caution about the upcoming earnings season, their weekly forward revenues and forward earnings both rose to record highs during the 6/20 week ([Fig. 3](#)). The former is a very good coincident indicator of actual quarterly S&P 500 revenues per share, while the latter is a good leading indicator of actual quarterly EPS (as long as there is no recession over the next 12 months).

Of course, the drop in the 10-year US Treasury bond yield just below 2.00% on expectations of more central bank easing is helping to boost the valuation multiple of the S&P 500.

So Joe and I are still targeting 3100 for the S&P 500 stock price index before the end of this year and 3500 as the high for next year.

Earnings II: Q2's Mixed Fundamentals for Earnings. In any event, we will be monitoring the Q2 earnings season very carefully for signs that companies are experiencing a significant slowdown in their business, as suggested by some—but not all—of the US and global economic indicators over the past few months. Let's review what we know so far from a macroeconomic perspective:

(1) *Consumers.* Notwithstanding May's weak jobs report, consumers are in very good shape. Wage

gains have been outpacing consumer price increases at a faster pace this year than last year. As a result, real average hourly earnings for production and nonsupervisory workers has been rising at a faster pace—into record-high territory this year through April—than during last year ([Fig. 4](#)). On a y/y basis through April, real disposable income is up 2.2%, while real personal consumption expenditures is up 2.7% ([Fig. 5](#)).

There may be a hint of trouble showing up in the Consumer Confidence Index (CCI) survey. The CCI fell during June by 9.8 points, with the current conditions and expectations components down 8.1 points and 10.9 points, respectively ([Fig. 6](#)). This survey is very sensitive to labor-market conditions.

While initial unemployment claims remain near recent historical cyclical lows, the percentage of CCI respondents saying that jobs are hard to get jumped from 11.8% in May to 16.4% in June, the highest since November 2017 ([Fig. 7](#)). That's still very low, but it does suggest that the unemployment rate may stop falling soon. Could it be that jobs are getting harder to find for some of the unemployed who don't have the right skill sets?

Meanwhile, forward revenues and forward earnings for the S&P 500 Consumer Discretionary sector both were at record highs during the 6/20 week ([Fig. 8](#)). Industry analysts are forecasting that the sector's revenues will grow 4.5% this year and 5.7% next year, while earnings are expected to grow 7.4% this year and 12.1% next year ([Fig. 9](#)).

Within the sector, there are lots of divergences. For example, S&P 500 Department Store revenues and earnings (both per-share) are expected to drop this year by 0.5% and 15.8%, respectively. On the other hand, S&P 500 Home Improvement is expected to be up 2.5% and 6.5%, respectively, over the comparable period.

(2) *Housing*. New home sales fell 11.2% during the two months through May after soaring 25.0% the first three months of the year; sales are up 11.0% ytd. The National Association of Home Builders index has risen from 56 at the end of last year to 64 during June, and the S&P 500 Homebuilding Index is up 28.2% ytd through Monday's close ([Fig. 10](#)).

The drop in mortgage rates since late last year should continue to boost mortgage applications for purchases of both new and existing single-family homes ([Fig. 11](#)). The former has been on an uptrend since early 2015, suggesting that rising household formation is finally boosting homeownership.

(3) *Capital goods & technology*. In May, industrial production of business equipment was down 1.6% ytd, led by a 1.2% drop in industrial equipment and a 6.7% decline in transit equipment ([Fig. 12](#)). On the other hand, sales of medium-weight and heavy trucks jumped to a new cyclical high of 547,000 units (saar) during May ([Fig. 13](#)).

Industrial production of information processing equipment rose 5.2% y/y during May to a new record high. Leading the way has been output of communication equipment, with semiconductor production increasing 3.9% ytd through May ([Fig. 14](#)). Output of computer and peripheral equipment has stalled in record-high territory since mid-2017.

Industrial production of defense and space equipment is up 2.4% ytd and 9.8% y/y through May ([Fig. 15](#)). Industry analysts are currently projecting that S&P 500 Aerospace & Defense earnings will be up only 3.7% this year, but 21.2% next year ([Fig. 16](#)).

(4) *Transportation*. The ATA Truck Tonnage Index went into reverse during May, falling 6.1% m/m following April's 7.0% jump ([Fig. 17](#)). However, the 12-month average of this index rose to a new record

high. On the other hand, total railcar loadings fell 2.3% y/y (using the 26-week moving average) through the 6/15 week. That does not augur well for industrial production, which was still up 2.0% y/y in May.

Nevertheless, industry analysts expect that S&P 500 Railroads revenues and earnings per share will increase 2.6% and 14.2%, respectively, this year and 4.3% and 12.4% next year.

(5) *Energy & commodities.* The price of a barrel of West Texas crude oil has increased 26% since its recent bottom on 12/24. The forward earnings of the S&P 500 Energy sector is very highly correlated with the price of oil ([Fig. 18](#)).

As we observed last Thursday, while industrial commodity prices have been weak this year, the S&P 500 Materials sector is up 14.8% ytd through Tuesday, led by Construction Materials (33.6%), Industrial Gases (33.0), and Specialty Chemicals (12.2) ([Fig. 19](#)).

(6) *Financials and asset management.* While the yield curve has inverted recently, banks are still making loans because their net interest margins remain profitable. Commercial and industrial loans at US commercial banks rose \$35 billion ytd through the 6/12 week to a record high of \$2.35 trillion ([Fig. 20](#)). Residential and commercial real estate loans are up \$50 billion and \$43 billion ytd to record highs ([Fig. 21](#)).

Asset management companies are continuing to experience net outflows from equity mutual funds, while equity ETFs continue to attract large inflows ([Fig. 22](#)). Meanwhile, bond mutual funds and ETFs also are attracting lots of investors.

(7) *The dollar & global business.* The trade-weighted dollar is up only 1.5% y/y ([Fig. 23](#)). So it shouldn't have much impact on Q2 earnings comparisons versus a year ago. A more significant negative impact on earnings is likely to be the slowdown in global growth. The Eurozone's M-PMI is down to 47.8 during June from 54.9 a year ago. Japan's comparable index is down to 49.5 from 53.0. Germany's Ifo business confidence index fell from a record high of 105.0 during November 2017 to 97.4 during this month. That's the lowest reading since November 2014 ([Fig. 24](#)).

While there are still plenty of solid economic indicators in the US, it's getting harder to find even a few overseas. With a magnifying glass, it is possible to detect an upturn in the Baltic Dry Index so far this year through the 6/24 week ([Fig. 25](#)).

Earnings III: The Foreign Slice. What percentage of S&P 500 revenues is from abroad? Two different analyses from S&P Global show different results. It's an important question right now, especially since global growth has been slowing more noticeably than domestic growth and also since geopolitics and trade are hot-button issues right now. Overseas economies and geopolitical events have the potential to significantly impact S&P 500 companies' results in the coming months.

An August 2018 [report](#) by Howard Silverblatt in S&P Global's core research division is titled "S&P 500 2017: Global Sales." Howard noted that foreign issues were removed from the S&P 500 during 2002, but lots of "American" companies are global. A March 2018 [report](#) by Phillip Brzenk in S&P Global's equity research division is titled "The Impact of the Global Economy on the S&P 500." Phil notes that the index captures approximately 82% of the total US equity market value, with many of the 500 companies having a global presence.

Both reports agree that it is hard to determine the foreign sales exposure of the S&P 500 precisely because such disclosure is not required of public companies. Exposure is somewhere between 30%-45% based on these analyses. I asked Melissa to have a closer look at the two reports:

(1) *S&P vs S&P*. According to Phil, nearly 71% of S&P 500 revenues came from the US at the end of 2017, with about 29% coming from overseas. According Howard's report, the share of domestic revenues was markedly lower, at 56%, with 44% coming from foreign markets.

(2) *Exposure by country*. In Phil's report, the largest foreign sales exposures by country were China (4.3%), Japan (2.6), and the UK (2.5). In Howard's report, the foreign sales breakdown by region was as follows: Asia (8.3), Europe (8.1), Africa (3.9), Canada (2.2), and Japan (1.5). According to this report, most companies with foreign sales did not break down sales by region, categorizing them broadly as "foreign sales," which explains the relatively low shares by region reported.

(3) *Exposure by sector*. Phil found that the sectors with the most foreign exposure (based on a sales-weighted average of the exposures of each stock in the sector) were Information Technology (59%), Materials (47), and Energy (42). Howard's report showed that Information Technology had the most foreign exposure (as a percentage of sector sales) of any sector, at 57%, closely followed by Energy (54), Materials (53), Industrials (45), Utilities (41), Health Care (38), Consumer Discretionary (34), Consumer Staples (33), and Financials (31).

(4) *Time period*. Howard's report observed that the geographic mix of non-US revenues has not fluctuated all that much over the past several years: 43.6% (2017), 43.2% (2016), 44.3% (2015), and 47.8% (2014). Phil's report studied the impact of the 2016 election on global sales. So the timeframe of the data used in that report was from Election Day, 11/8/16 through the end of 2017.

(5) *Data source & methodology*. Phil's report utilized the FactSet Geographic Revenue Exposure (GeoRevTM) dataset, which gives a geographic breakdown of revenues for all companies with available data. According to FactSet's [website](#) on the product, the dataset relies "on a calculation engine that algorithmically distributes revenues from disclosed region to country level." In other words, these data are extrapolated using a proprietary methodology from the available data to become more meaningful.

Phil helpfully confirmed to us that the FactSet data scrubs additional sources published by each company for more details and breaks regional reporting down to the country level by breaking out revenue percentages by relative country GDP. In his opinion, you lose out on a lot of valuable information if you go explicitly by what each company reports. Using relative GDP is a simple, objective, and numbers-driven approach to weight the data.

Howard's report based its findings on publicly available filings or press releases (provided by S&P Global Market Intelligence) as of the fiscal year-end 2017 (using data available through July 2018). Based on the current 2017 reports, foreign sales appear to account for 27.2% of sales. However, if only the companies that reported foreign sales are used, the rate increases to 38.5%. If anomalies are excluded, the rate is 43.6%, which is the rate used for guidance.

(6) *Disclaimer*. "Given the ongoing debate and legislative actions on sales, tariffs, and jobs, the level of specific data disclosed by companies continues to be disappointing," Howard observed. He noted that exact sales are difficult to obtain. Companies' sales categorization is inconsistent, for example by regions and markets. Further, intracompany sales are "sometimes structured to take advantage of trade, tax, and regulatory policies. Changes in domicile, inspired by tax savings, have also changed the technical classification of what is considered foreign."

Therefore, there are limited data available to complete a comprehensive analysis. So no report on S&P 500 foreign sales should be considered precise. In fact, geographical data tables are not generally

required under Generally Accepted Accounting Principles. As a result, only about one-half of issuers included report on them, Howard noted.

CALENDARS

US. Wed: Durable Goods Orders Total & Ex Transportation -0.1%/0.1%, Core Capital Goods Orders & Shipments 0.1%/-0.2%, Advanced Merchandise Trade Balance -\$71.9b, Wholesale Inventories 0.5%, DOE Crude Oil Inventories. **Thurs:** Real GDP & PCE 3.2%/1.3%, GDP & Core PCE Deflators 0.8%/1.0%, Jobless Claims 219k, Kansas City Fed Manufacturing Index 0.0, EIA Natural Gas Report, Pending Home Sales 1.0%. (DailyFX estimates)

Global. Wed: Germany Gfk Consumer Confidence 10, Japan Retail Trade 0.6%m/m/1.2%y/y, Carney. **Thurs:** Eurozone Consumer Confidence 104.7, Germany CPI 0.2%m/m/1.4%y/y, UK Gfk Consumer Confidence -11, Japan Jobless Rate 2.4%, Japan Industrial Production 0.7%m/m/-3.0%y/y, Japan CPI Headline, Core, and Core-Core 1.0%/1.0%/0.8% y/y. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Sectors Net Earnings Revisions ([link](#)): The S&P 500's NERI was positive in June for a second month, but barely so as it weakened for the first time in four months. The index's 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 fell to 0.1% in June from 0.8% in May, which compares to a record high of 22.1% in March 2018. NERI improved m/m for six of the 11 sectors; that compares to all improving in May, which was the first time that had happened since January 2018. NERI was positive for 5/11 sectors, up from four in May, which compares to negative readings for all 11 sectors from February to April. Consumer Staples' NERI turned positive in June for the first time in 14 months. Materials has the worst track record, with nine months of negative NERI, followed by Communication Services (8) and Industrials (8). Here are the sectors' June NERIs compared with their May readings: Health Care (9.1% in June, up from 8.0% in May), Real Estate (4.9 [23-month high], 0.3), Energy (2.7, 4.1), Consumer Staples (0.9, -1.6), Tech (0.8, 4.6), Communication Services (-0.5, -1.4), Financials (-1.0, 0.0), Utilities (-1.5, -1.6), Consumer Discretionary (-2.3, -0.2), Industrials (-2.8, -3.8), and Materials (-12.1, -9.3).

S&P 500 Earnings, Revenues, Valuation & Margins ([link](#)): Consensus S&P 500 forward revenues were stalled near a record high, and forward earnings rose for a tenth straight week to their third straight record high since early December. Analysts expect forward revenues growth of 5.3% and forward earnings growth of 7.5%. Forward revenues growth is down 1.0ppt 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 9.4ppts 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 8.5% in 2018 to 4.5% in 2019 and 5.3% in 2020. They're calling for earnings growth to slow sharply from 24.1% in 2018 to 2.9% in 2019 before improving to 11.0% in 2020. The forward profit margin was steady w/w at 12.2%, and is down just 0.2ppt from a record high of 12.4% in mid-September. That compares to 11.1% prior to the passage of the TCJA in December 2017 and a 24-month low of 10.4% in March 2016. Analysts are expecting the profit margin to fall from 12.0% in 2018 to 11.8% in 2019 before rising to 12.4% in 2020. The S&P 500's forward P/E rose 0.3 point w/w to a seven-week high of 16.8, but is down from an eight-month high of 17.0 in late April. 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 improved w/w to an eight-week high of 2.04 from 2.01. That's 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 three of the 11 S&P 500 sectors and forward earnings for 2/11 sectors. Consumer Staples 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 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. 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 (15.7, down from 17.0), Communication Services (14.9, down from 15.4), Utilities (13.0, matching its record high in mid-May), S&P 500 (12.2, down from 12.4), Materials (10.3, down from 11.6), Health Care (10.5, down from 11.2), Industrials (10.4, matching its record high in mid-March), Consumer Discretionary (7.7, down from 8.3), Consumer Staples (7.4, down from 7.7), and Energy (7.2, down from 8.0).

US ECONOMIC INDICATORS

Consumer Confidence ([link](#)): Consumer confidence in June fell to its lowest level since September 2017, and there were sizeable downward revisions to the May measures. Lynn Franco, senior director of economic indicators at the Conference Board, notes: "The escalation in trade and tariff tensions earlier this month appears to have shaken consumers' confidence. Although the Index remains at a high level, continued uncertainty could result in further volatility in the Index and, at some point, could even begin to diminish consumers' confidence in the expansion." Consumer confidence sank to 121.5 this month after climbing from 121.7 in January to 131.3 in May (vs the 134.1 initial estimate), as consumers were less optimistic about both the present and future. The present situation component fell from 170.7 (vs 175.2) last month to 162.6 this month—driven by a less favorable assessment of business and labor market conditions. The percentage of respondents saying that jobs are plentiful fell for the second month, from 46.5% in April to 44.0% this month—holding near its cyclical high of 46.8%—while those saying jobs are hard to get jumped from 11.8% in May to a 19-month high of 16.4% this month. A deterioration in the six-month job outlook pushed the expectations component lower, from a six-month high of 105.0 (vs 106.6) in May to 94.1 this month. The percentage of respondents expecting more jobs (to 17.3% from 18.4%) fell this month, while those expecting fewer jobs (14.8 from 13.0) rose, though the spread remained positive—narrowing to 2.5ppts this month from 5.4ppts last month. It had turned negative back in January for the first time since August 2016.

Regional M-PMIs ([link](#)): Four Fed districts have reported on manufacturing activity for June so far—Philadelphia, New York, Dallas, and Richmond—and collectively show that growth contracted for the first time since August 2016, as activity in all four regions deteriorated. We average the composite, orders, and employment measures as data become available. The composite (to -4.4 from 8.5) index showed growth slipped into negative territory this month after holding around this year's high in May. The New York region's composite (to -8.6 from 17.8) index denoted activity contracted for the first time since October 2016, plunging 26.4 points in June (its biggest monthly decline on record), while Dallas' (-12.1 from -5.3) contracted at its fastest pace since June 2016. Meanwhile, Philadelphia's (0.3 from 16.6) showed activity in that region was at a standstill, while Richmond's (3.0 from 5.0) appears to be heading in that direction. The new orders gauge (0.3 from 5.8) was the weakest since September 2016,

showing no growth, driven by a sizable decline in billings in the New York (-12.0 from 9.7) region. Meanwhile, Philadelphia (8.3 from 11.0) manufacturers showed a slight slowing in orders growth, while Dallas' (3.7 from 2.4) showed a slight acceleration—though was weaker than Philly's pace; orders' growth in the Richmond (1.0 from 0.0) region was basically flat. The employment index (5.7 from 12.9) revealed factories hired at roughly half May's pace—and the weakest since December 2016. Manufacturers in the Philadelphia (15.4 from 18.2) region continued to add to payrolls at a healthy pace, while New York's (-3.5 from 4.7) cut jobs for the first time since January 2017. Meanwhile, factories in the Dallas (8.8 from 11.6) region have been hiring at a fairly steady rate through the first half of this year, while Richmond's (2.0 from 17.0) pace slowed dramatically this month.

Regional Manufacturing Price Indexes ([link](#)): Available June data for New York, Philadelphia, Dallas, and Richmond show pricing remains on a disinflationary trend, based on both the prices-paid and prices-received indexes, though Dallas' prices-paid index moved up in June, while New York's same measure appears to have found a bottom in recent months. Here's a look at the prices-paid indexes for June versus their respective peaks during 2018: Philadelphia (to 12.9 from 60.0), New York (27.8 from 54.0), Dallas (16.4 from 54.2), and Richmond (1.6% from 5.7% y/y). Here's the same comparisons for the prices-received indexes: Philadelphia (0.6 from 35.0), New York (6.8 from 23.3), Dallas (1.2 from 26.2), and Richmond (1.7 from 2.8). (Note: Richmond prices are not diffusion indexes but rather average annualized inflation rates.)

New Home Sales ([link](#)): New home sales fell for the second month in May, though are still up on a ytd basis. New home sales sank 11.2% during the two months through May to 626,000 units (saar), after a three-month jump of 25.0% to 705,000 units in March—which was the best sales pace since November 2017. Sales are up 11.0% ytd, led by double-digit gains in the Midwest (29.2% ytd) and South (10.8), while increases in the Northeast and West were a more modest 3.7% and 3.3%, respectively, as sales for both tumbled in May. The supply of new homes on the market last rose slightly to 333,000 units, after falling from 347,000 to 332,000 units the prior three months; the months' supply rose to 6.4 months from 5.9 in April. About two-thirds of the homes sold last month were either under construction or yet to be built. The National Association of Home Builders Housing Market Index (HMI) for June shows homebuilders' confidence took a small step back, to 64, after climbing 10 points the first five months of this year to 66. All three components ticked lower this month, though are still up noticeably over the first half of this year: current sales conditions (to 71 from 61), expected sales (70 from 61), and buyer traffic (48 from 43).

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