MORNING BRIEFING
July 18, 2019

Consumers Unchained

See the collection of the individual charts linked below.

(1) Consumers spending like there's no tomorrow—just not at department stores. (2) Retail sales hit another record high. (3) Flying consumers send airline earnings flying. (4) Consumer borrowing boosts bank earnings. (5) Transports yet to make a new high. (6) Senate throws the book at Facebook's Libra. (7) Trump, Mnuchin, Powell, and France question the digital currency.

US Consumer: Spending Everywhere. The US consumer continues to keep the bull market moving forward. This week saw bank earnings bolstered by consumer lending, retail sales up strongly, and airline earnings kept aloft by travelers willing to spend.

As we mentioned in last Thursday's *Morning Briefing*, all of the S&P 500 Consumer Discretionary industries' stock price indexes—with the notable exceptions of Department Stores and Housewares & Specialties—are up strongly ytd. Joe notes that of the 22 Consumer Discretionary industries with gains, 21 are up by double digits. This week's news reports have confirmed investors' bullish expectations for consumer-related stocks.

Here's the performance derby for the S&P 500's sectors ytd through Tuesday's close: Technology (30.1%), Consumer Discretionary (26.3), Communication Services (23.0), Industrials (22.1), Real Estate (21.1), S&P 500 (19.8), Consumer Staples (18.3), Financials (17.8), Materials (16.0), Utilities (14.3), Energy (10.2), and Health Care (6.5) (*Fig. 1*).

Let's take a look at how consumer spending continues to keep the earnings parade rolling along:

(1) *Remarkable retail sales.* Consumer spending drove retail sales to the latest record high in June, Debbie reports (*Fig. 2*). Total real retail sales climbed 3.9% (saar) during Q2. Excluding building materials, the figure is even higher, at 5.4%; when autos, gasoline, building materials, and food services are excluded, it's still higher than the total, at 4.0% (*Fig. 3*).

Consumers continue to shop 'til they drop online and shun department stores (*Fig. 4* and *Fig. 5*). They're also spending mightily in warehouse clubs and eating and drinking establishments (*Fig. 6* and *Fig. 7*). Even spending on motor vehicles and at parts dealers hit a new high last month (*Fig. 8*).

(2) *Consumers in the air*. Strong demand for travel helped United Airlines Holdings post Q2 profit growth of 54% y/y, to $1.1 billion. To meet future demand, United signed an agreement to buy 19 used Boeing 737-700 planes. It has grounded 14 737 Max 9 jets through the start of November. The 737 groundings mean that the airline's capacity will only grow by 3%-4%, less than 4%-5% before the groundings.

United's shares are up 5.1% over the past five trading sessions, helping boost the Dow Jones Transportation Average (DJTA) by 4.9% since last Wednesday (*Fig. 9*). Another member of that index, J.B. Hunt Transport Services, gave investors a "relatively upbeat outlook for the months ahead," a 7/16 *WSJ* article reported.

The paper quoted Shelley Simpson, Hunt's CFO, on the earnings call saying: "From a demand perspective, our customers are optimistic. They did recognize the level of inventory that they brought in [was] incremental to avoid what was happening around tariffs, but they're starting to work through that inventory and feel better about the back half of the year." That helped lift the company's stock by 5.6% in the aftermarket on Tuesday.

By the way, after having the strongest performance among the Transports, up almost 30% ytd, the S&P 500 Railroad industry is showing some signs of running out of steam. CSX told investors in its conference call to expect a 2% drop in revenue this year, instead of its earlier forecast for a 1%-2% increase. The rail operator's CEO Jim Foote blamed the reduced forecast on lower coal deliveries in the wake of low natural gas prices, lower volumes in intermodal traffic, and weakness in demand from the company's industrial customers. In addition, CSX was affected by the shutdown of a refinery, to which it had delivered crude oil. The earnings report once again highlights the difference between the industrial economy, hurt by US/Chinese trade negotiations, and the consumer economy that so far has been left unscathed by trade tensions.

The Dow Transports are now 6.7% off their 9/14 high, edging closer to confirming the latest new high the Dow Jones Industrial Average made this week. As we noted in Tuesday's *Morning Briefing*, the DJTA has been held back by the companies in the Air Freight & Logistics industry, including FedEx, which have been hampered by the slowdown in international trade as well as the threat that Amazon will continue to build out its own delivery network. The S&P 500 Air Freight & Logistics remains 24.1% below its record high on 1/12/2018.

(3) *Consumers boost banks*. With trading in the doldrums and net interest margins under pressure, consumer lending saved the day at many of the banks that reported earnings this week (*Fig. 10*).

Bank of America reported yesterday that its net interest income rose 3% y/y but fell 1.5% q/q. Net income jumped 13% in the consumer banking segment and 11% in the global wealth management division, but fell 9% in global banking. Adjusted global sales and trading revenue slid 10%.

CEO Brian Moynihan highlighted the consumer's strength: "Our view of the economy reflects the activity by the one-in-two American households we serve, which points to a steadily growing economy. We see solid consumer activity across the board, with spending by Bank of America consumers up five percent this quarter over the second quarter of last year."

At Bank of America's consumer banking unit, average loans and leases grew 5.6% y/y, while credit card balances were flat. US consumer credit outstanding has been growing steadily since 2010, with auto and student loans growing sharply (*Fig. 11* and *Fig. 12*). But consumers' debt-service ratio—the ratio of debt-service payments to disposable personal income—remains near 30-year lows (*Fig. 13*).

PNC's Q2 earnings also benefitted from its consumer business. The bank's net interest margin shrank 0.05ppts y/y to 2.91%, but income rose in retail banking by 18.6% y/y while falling in corporate & institutional banking by 8.3%. Average loans outstanding increased y/y in both areas: 4% in retail and 7% in commercial & institutional, according to the company's press release.

However, the commercial business was hurt by a jump in the provision for credit losses to $100 million in Q2 from $15 million a year earlier. In the retail business, the y/y increase in the provision for credit losses was only $9 million, to $81 million.

Finance: Libra Grilling. Facebook's past actions have angered both Democrats and Republicans, so Facebook's David Marcus, vice president of Messaging Products, faced a tough audience when he testified Tuesday in front of the Senate Banking Committee. Senators repeatedly noted their distrust of Facebook and the company's need to resolve the problems in its existing businesses. However, some senators did express appreciation for the company's technological innovation and voiced a desire for the US to lead in the era of digital currency.

The senators' questions and diatribes were the latest pushback that Facebook and its Libra digital currency have faced. Here are some of the takeaways from the Senate hearing and recent news reports:

(1) *Really for the unbanked?* Facebook has made much ado about how Libra will help bring the 1.7 billion people without access to the banking system into the financial fold by providing financial services to those without bank accounts at much lower costs than anyone offers currently. Broadening access to the banking system is a common discussion theme in Congress. Who wouldn't like to reduce financial costs to consumers and increase the number of banking clients?

However, Facebook did little to explain how hard currency would actually be turned into Libra by people without a bank account. Facebook's white paper says the firm is in discussions with "principal cryptocurrency trading firms and top banking institutions as authorized resellers to allow people the opportunity to exchange their local currencies for Libra as easily as possible." But currency exchanges exist today, and they charge a lot. Why will Libra's currency exchanges charge less?

(2) *Identity verification*. Facebook's Marcus continually noted that fraud would be avoided because customers would need to enter their government identification in order to open a Libra account. But we wonder just how many of the unbanked have government IDs and how Facebook intends to ensure that the ID is valid and not a fake.

(3) *Who's responsible?* Many questions centered around who would be responsible if a customer's account was hacked or if the customer fell victim to fraud. Is it the wallet provider? What happens if the wallet provider is an overseas company? US banking customers are used to being made whole if their banking account is hacked, and credit card customers are made whole when defrauded.

Another line of inquiry targeted Libra's unwieldy structure, with its headquarters in Switzerland and 100 founding members who elect a board of 5-19 people, who in turn elect a managing director. One senator went as far as to jokingly compare it to SPECTRE, the fictional, evil organization in the James Bond films that isn't allied with any government.

(4) *Mnuchin, Trump, Powell are doubtful.* The three most powerful folks in government have expressed reservations about Libra. Treasury Secretary Steven Mnuchin in a press conference Monday said that Libra "could be misused by money launderers and terrorist financiers." He compared it to cryptocurrencies, which have been used in illicit activities like drug and human trafficking.

Mnuchin's comments came a few days after President Donald Trump tweeted that he was "not a fan" of cryptocurrencies like bitcoin. He added: "If Facebook and other companies want to become a bank, they must seek a new Banking Charter and become subject to all Banking Regulations, just like other Banks, both National and International."

Fed Chair Jerome Powell added his voice to the mix when testifying before the Senate Banking Committee last week: "I think we agree that Libra raises a lot of serious concerns, and those would include around privacy, money laundering, consumer protection, financial stability," he said. "Those are going to need to be thoroughly and publicly assessed and evaluated before this proceeds," a 7/11 *WSJ* article reported.

(5) *Objections from abroad*. France's Finance Minister Bruno Le Maire also raised objections to Libra. Countries have strong rules and commitments regarding their currencies. "We cannot accept a new currency having the exact same kind of power, without the same kind of rules, without the same kind of commitments, and without the same kind of obligations," he said according to a 7/17 CNBC article. In addition, he raised concerns about the potential for money laundering and the funding of terrorism using Libra. Marcus is facing an uphill battle.

CALENDARS

US. Thurs: Leading Indicators 0.1%, Jobless Claims 216k, Philly Fed Manufacturing Index 5.0, EIA Natural Gas Report, Williams. **Fri:** Consumer Sentiment Index 98.6, Baker-Hughes Rig Count, Bullard, Rosengren. (DailyFX estimates)

Global. Thurs: UK Retail Sales Ex Auto Fuel 2.6% y/y, Canada Employment Report, Japan Headline, Core, and Core-Core CPI 0.7%/0.6%/0.5% y/y, Australia Employment Change & Unemployment Rate 9k/5.2%, BOE Bank Liabilities and Credit Conditions Surveys. **Fri:** Japan All Industry Activity Index 0.3%, Canada Retail Sales 0.3%. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) rose this week for the sixth consecutive week, climbing further above 3.00, as bullish sentiment jumped to another new high for this year. The BBR advanced for the sixth week to 3.45 (the highest since mid-March 2018) after sliding the prior five weeks from 3.17—which was the first reading above 3.00 since October—to 2.31 (lowest since mid-February). Bullish sentiment has soared 15.3ppts over the six-week period, to 58.0%, after a five-week plunge of 13.7ppts, from 56.4% to 42.7%—which was the fewest bulls since the first week of this year. While the move up in bullish sentiment (to 58.0% from 56.7%) this week came from the bearish camp—with bearish sentiment falling to 16.8%, after fluctuating in a small band from 18.0% to 18.5% the prior seven weeks—the six-week move up in bullish sentiment came primarily from the correction camp. The correction count (25.2 from 25.0) was little changed this week, though is down 13.6ppts over the past six weeks, from 38.8%—which was the highest percentage since just before Christmas. The AAII Ratio rose for the fifth week last week to 55.0% after a four-week decline from 65.0% to 34.6%. Bullish sentiment increased from 22.5% to 33.6% over the five-week period, while bearish sentiment fell from 42.6% to 27.5%.

S&P 500 Q2 Earnings Season Monitor (*link*): With the Q2 earnings season 9% complete, the early indications compared to the same point during Q1 show that a sharply higher percentage of companies is reporting positive revenue surprises and y/y revenue growth, and the revenue and earnings beats are slightly larger too. However, these figures will continue to change as more Q2-2019 results are reported in the coming weeks. Of the 45 S&P 500 companies (nearly 7% of the total) that have reported through midday Wednesday, 82% exceeded industry analysts' earnings estimates. Collectively, these reporters have averaged a y/y earnings gain of 6.6%, and exceeded forecasts by an average of 5.2%. On the revenue side, 69% of companies beat their Q2 sales estimates so far, with results coming in 1.1% above forecast and 2.6% higher than a year earlier. Q2 earnings growth results are positive y/y for 73% of companies, versus a lower 69% at the same point in Q1, and Q2 revenues have risen y/y for 82% versus a much lower 72% during Q1. Looking at earnings during the same point in the Q1-2018 reporting period, a slightly lower percentage of companies (80%) in the S&P 500 had beaten consensus earnings estimates by a slightly higher 5.7%, and earnings were up a lower 3.8% y/y. With respect to revenues at this point in the Q1 season, a sharply lower 46% had exceeded revenue forecasts by a much lower 0.4%, but sales rose a slightly higher 3.2% y/y. Compared to 2018's stellar results, these early readings for Q2 indicate a continuation of a marked slowdown in revenue and earnings growth and a slight deterioration in profit margins. But that should come as no surprise to investors. Q1-2019 had marked the 11th straight quarter of positive y/y earnings growth and the 12th of positive revenue growth. However, earnings growth trailed revenue growth during Q1-2019 for the first time since Q2-2016. That has happened just five times in the 42 quarters since the bull market started in Q1-2009; quite possibly, Q2-2019 will make the sixth.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): Consensus S&P 500 forward revenues rose to a record high during the week of 7/11, but forward earnings stalled at a record. Analysts expect forward revenues growth of 5.2% and forward earnings growth of 7.8%, with each metric down 0.1ppt w/w. Forward revenues growth is now down 1.1ppt 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 9.5ppts from a six-year high of 16.9% last February, but has improved steadily 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 4.3% in 2019 and 5.3% in 2020. They're calling for earnings growth to slow sharply from 24.1% in 2018 to 2.4% in 2019 before improving to 10.8% in 2020. The forward profit margin was steady w/w at 12.1%, and is down just 0.3ppt 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 11.7% in 2019 before rising to 12.3% in 2020. The S&P 500's forward P/E edged down 0.1 point w/w to 17.1 from a 14-month high of 17.2. 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 also edged down w/w, to 2.07 from a 10-month high of 2.08. 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 six of the 11 S&P 500 sectors and forward earnings for 5/11 sectors. Consumer Discretionary was the only sector to have both measures rise w/w. Financials and Materials saw both measures decline. 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 at multi-year or record 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. Here's how the sectors rank based on their current forward profit margin forecasts versus their highs during 2018: Information Technology (21.9%, down from 23.0%), Financials (18.6, 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 (12.1, down from 12.4), Materials (10.3, down from 11.6), Health Care (10.5, down from 11.2), Industrials (10.3, down from its record high of 10.4 in early July), Consumer Discretionary (7.6, down from 8.3), Consumer Staples (7.4, down from 7.7), and Energy (7.2, down from 8.0).

US ECONOMIC INDICATORS

Housing Starts & Building Permits (*link*): The housing market remains in a rut, with housing starts in June remaining in a volatile flat trend and building permits sinking to a two-year low. Meanwhile, homebuilders' optimism improved again in July, though builders complained. They "continue to grapple with labor shortages, a dearth of buildable lots and rising construction costs that are making it increasingly challenging to build homes at affordable price points relative to buyer incomes." Housing starts dropped 1.3% during the two months ending June, to 1.253mu (saar), after jumping 10.5% during the two months ending April. June's decline reflected a 9.2% drop in volatile multi-family starts to 406,000 units (saar) after soaring 37.5% during the four months through May to a 16-month high. Meanwhile, single-family starts advanced for the third time in four months, by 3.5% in June and 6.9% over the period to 847,000 units (saar), yet remained 12.3% below January's spike to 966,000 units. Building permits slumped 6.1% last month to 1.220mu (saar)—the lowest level since May 2017—as multi-family permits tumbled 16.8% to 407,000 units (saar). Meanwhile, single-family permits were little changed at 813,000 units (saar) after rebounding 3.1% in May—which was the first advance in eight months. The National Association of Home Builders Housing Market Index (HMI) for July shows homebuilders' confidence rose for the fifth time this year, with all three components trending higher through the first seven months of this year: current sales conditions (to 72 from 61 in December), expected sales (71 from 61), and buyer traffic (48 from 43).

GLOBAL ECONOMIC INDICATORS

Eurozone CPI (*link*): June's CPI rate remained below 2.0% for the eighth consecutive month, while the core rate moved back above 1.0%. The headline rate ticked up to 1.3% y/y in June (slightly above the 1.2% flash estimate), after easing from 1.7% in April to a 13-month low of 1.2% in May; it was at a recent peak of 2.3% in October. Looking at the main components, energy (to 1.7% from 3.8%) recorded the highest yearly inflation rate, though eased for the second straight month, followed closely by food alcohol & tobacco (1.6 from 1.5) and services (1.6 from 1.0). The rate for non-energy industrial goods was unchanged at 0.3%. The core rate—which excludes energy, food, alcohol, and tobacco—accelerated 1.1% y/y after decelerating from 1.3% to 0.8% in May. Of the top four Eurozone economies, rates for

Germany (1.5% y/y) and France (1.4) were above June's 1.3% headline rate, while rates in Italy (0.8) and Spain (0.6) were below. Greece (0.2) and Cyprus (0.2) posted the lowest rates in the Eurozone.

European Car Sales (*link*): EU passenger car registrations (a proxy for sales) took a dive in June, after sales had stabilized in May following a nine-month slide. Sales fell 7.8% y/y last month, the sharpest decline since December, with the European Automobile Manufacturer's Association (ACEA) attributing the loss to a negative calendar effect. According to ACEA's report, "On average, June only counted 19 working days across the EU this year, compared to roughly 21 days in 2018," causing the five major EU markets to post declines. (While the calendar effect had an impact, it's worth noting that German manufacturer Daimler AG has issued several profit warnings the past year, while BMW AG in May posted a quarterly loss in its automotive division for the first time in a decade.) Looking at the five major markets, France (-8.4% y/y) and Spain (-8.3) posted the largest declines in sales, followed by the UK (-4.9), Germany (-4.7), and Italy (-2.1). On a ytd basis, demand for passenger cars fell 3.1% y/y compared to the same period a year ago, causing concerns that European car sales could post a second consecutive annual decline. Germany (0.5) was the only major market to show an increase during the first half of this year (compared to the same 2018 period), while sales in Spain (-5.7), Italy (-3.5), UK (-3.4), and France (-1.8) all were in the red.

Contact us by email or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-775-6823