MORNING BRIEFING
July 22, 2019

Mixed Signals

See the collection of the individual charts linked below.

(1) Trucks are rolling along better than freight trains. (2) Consumers boost some bank earnings. (3) Forward earnings at another record high. (4) Typical earnings hook ahead? (5) S&P 500 profit margin remains very profitable. (6) Lots of questions about valuation. (7) Low Misery Index boosting P/Es. (8) Real earnings yield fairly valued. (9) Buffett says ignore Buffett Ratio. (10) The economic data are mixed, while the Fed's Williams is mixed up. (11) Is near-zero inflation really an "insidious disease?" (12) Clarida is ready to ease.

Strategy I: Earnings Are In Season. It is too early in the earnings reporting season to draw any firm conclusions. So far, we have mixed readings from transportation companies' revenues and earnings during Q2. Trucking companies are doing well, while railroads are more challenged. Jackie and I aren't surprised, since just last Tuesday we noted that truck freight tonnage has cruised to record highs in recent months, while railcar loadings are actually down on a y/y basis. (See "Truck & Train Spotting," in the 7/16 *Morning Briefing*.)

Also mixed were the earnings reports from the major banks. The ones that are most exposed to consumer lending did best. That's no surprise either, since both income and spending data for consumers have been very strong in recent months. (See "Consumers Unchained," in the 7/18 *Morning Briefing*.)

Now let's review the latest weekly stats on overall S&P 500 revenues and earnings:

(1) *Revenues.* Again, it's early in the earnings reporting season, but Joe is detecting that revenues might be stronger than some industry analysts expected for their S&P 500 companies that have reported so far. We won't be surprised if this continues to be the trend. That's because weekly S&P 500 forward revenues recovered nicely earlier this year from its swoon late last year, and has continued to rise in record-high territory during Q2 (*Fig. 1*). Consensus expected revenues estimates are holding up very well despite all the weak headline news about the global economy (*Fig. 2*). During the 7/11 week, industry analysts estimated that S&P 500 revenues will increase 4.3% this year and 5.3% next year (*Fig. 3*).

Joe and I have often observed that the weekly S&P 500 forward revenues per share is a very good coincident indicator of actual quarterly S&P 500 revenues per share (*Fig. 4*).

(2) *Earnings.* The consensus expected growth rate for S&P 500 earnings during Q2 continued to fall during the 7/11 week to -2.0% y/y from 4.9% at the beginning of the year (*Fig. 5* and *Fig. 6*). That's exactly the same downward revision as occurred for Q1, which turned out to be up 2.8%. We expect a similar earnings "hook" will evolve as the current earnings reporting season unfolds.

Meanwhile, S&P 500 forward earnings per share rose to a new record high of $176.00 during the 7/11 week as it converges toward the 2020 estimate, which is currently at $184.87 (*Fig. 7*). This series tends to be a good leading indicator for actual earnings a year from now (*Fig. 8*).

(3) *Profit margin.* Remarkably, the forward profit margin has been holding steady around 12.1% since the start of this year (*Fig. 9*). That's despite higher labor costs, higher tariffs, and a strong dollar. This suggests to us that companies may be succeeding in boosting their productivity to offset the pressure on margins.

Strategy II: Everyone Is Asking About Valuation. In recent weeks, as the S&P 500 has climbed to yet another record high, we have been getting more requests to discuss valuation. Chapter 14 of my book, *Predicting the Markets* (2018), examines the various models that are widely followed by investors to gauge valuation.

I concluded in the book that valuation, like beauty, is in the eyes of the beholder. In other words, it is more art than science. It is more subjective than objective. Nevertheless, Joe and I continue to monitor all the major valuation models, especially those that include the influence of inflation and interest rates. History shows that when both are high (low), valuation multiples tend to be low (high).

The conundrum is that in the current environment, we have historically low inflation and interest rates, but they are attributable to subpar domestic and global economic growth. Should investors be willing to pay high P/Es when inflation and interest rates are low, but growth is weak? That doesn't seem like a good deal. Then again, the combination of low inflation and interest rates with slow growth may result in a longer-than-usual economic expansion. The current one became the longest one on record just this month. If it keeps going, even at a slow pace, maybe it makes sense to pay relatively high P/Es.

On balance, Joe and I believe that the current mix of inflation and interest rates and economic growth merits relatively high, above-average valuations, especially for stocks of companies that can generate consistently above-average earnings growth. Let's have a look at some of the relevant valuation models:

(1) *Misery Index.* The simplest model incorporating inflation is the one showing the strong inverse correlation between the S&P 500 forward P/E and the Misery Index, which is the sum of the unemployment rate and the CPI inflation rate (*Fig. 10*). The Misery Index was very low at just 5.3% during June, justifying the month's forward P/E of 16.8, which is above the historical average reading of roughly 15.0.

(2) *Fed's Stock Valuation Model.* There was a relatively good fit between the S&P 500 forward earnings yield and the 10-year US Treasury bond yield from 1979 to 2001 (*Fig. 11*). Since then, they have diverged, suggesting either that stocks are a screaming buy relative to bonds or that bonds are grossly overvalued. At 2%, the bond yield matches the dividend yield of the S&P 500, making dividend-yielding stocks with growing dividends very attractive, in our opinion (*Fig. 12*).

(3) *Real Earnings Yield Model.* A valuation model that explicitly incorporates inflation is the one tracking the spread between the S&P 500 reported earnings yield and the CPI inflation rate (*Fig. 13*). Since 1952, the quarterly spread has averaged 3.3%. Bear markets were preceded by declines in the real earnings yield toward zero. During Q1, it rose back to the average, registering 3.5%.

(4) *Buffett Ratio.* If you are looking for overvaluation, you'll find it in the so-called Buffett Ratio, which is the market capitalization of all US equites (excluding foreign issues) divided by nominal GNP (*Fig. 14*). During Q1, it stood at 1.85, only a bit below its record high at the end of the bull market of the 1990s.

However, even Warren Buffett has cautioned that this valuation metric doesn't reflect that both inflation and interest rates are at record lows. So he is ignoring it. In a 5/6 CNBC interview, Buffett said stocks are a huge bargain if interest rates remain at their low levels. "I think stocks are ridiculously cheap if you believe ... that 3% on the 30-year bonds makes sense," Buffett said.

US Economy: Mixed Readings. Economists like rules of thumb. One of them is that when the Index of Leading Economic Indicators (LEI) falls three months in a row, a recession is likely to follow in short order. That hasn't happened yet. The LEI did drop 0.3% m/m during June, but that's after no change in May and a 0.1% uptick in April. It is down 0.2% over the past three months (*Fig. 15*). It has turned slightly negative before on this basis a few times during the current expansion without leading to a recession.

Nevertheless, economic growth seems to be slowing based on the Index of Coincident Economic Indicators (CEI), which is up only 1.6% y/y in June, the weakest since February 2017 (*Fig. 16*). This growth rate is highly correlated with the comparable growth rate for real GDP. By the way, the latest Atlanta Fed GDPNow estimate for Q2's real GDP is 1.6% (saar).

Debbie and I have some misgivings about the LEI. Its components are all very cyclical (*Fig. 17*). That makes sense in the context of forecasting the business cycle. However, many have run out of room to improve given that this has turned out to be the longest economic expansion on record.

For example, the average workweek has been fluctuating around its cyclical high since 2014. Jobless claims are so low that they probably can't go much lower. Building permits also have been moving sideways at their cyclical high since 2017. This might explain why the LEI has stalled at a record high over the past nine months through June, while the CEI has continued to make record highs.

By the way, as we have noted in the past, the yield-curve-spread component of the LEI is just one of the 10 components of the LEI. It has been getting lots of attention because it seems to be signaling a recession. Indeed, it turned negative in June for the first time since January 2008. The S&P 500 is another component of the LEI. We are siding with the stock market's upbeat message rather than the downbeat one from the credit market.

Another upbeat signal is coming from July's business surveys conducted by the Federal Reserve Banks of New York and Philadelphia (*Fig. 18*). The average of the general business indexes rebounded from -4.2 during June to 13.1 during July, led by very strong growth in the Philly region. The orders and employment sub-indexes also rose smartly this month. That augurs well for the national M-PMI for this month.

The Fed: Mixed Up. Say what? Last Thursday, FRBNY President John Williams gave a speech titled "Living Life Near the ZLB." "ZLB" stands for "zero lower bound." Apparently, for Williams, life near the ZLB is a bit discombobulating. In the speech, he said that based on simulation models, "monetary policy can mitigate the effects of the ZLB." He mentioned three ways:

(1) "The first: don't keep your powder dry—that is, move more quickly to add monetary stimulus than you otherwise might. When the ZLB is nowhere in view, one can afford to move slowly and take a "wait and see" approach to gain additional clarity about potentially adverse economic developments. But not when interest rates are in the vicinity of the ZLB. In that case, you want to do the opposite, and vaccinate against further ills. When you only have so much stimulus at your disposal, it pays to act quickly to lower rates at the first sign of economic distress."

(2) "This brings me to my second conclusion, which is to keep interest rates lower for longer. The expectation of lower interest rates in the future lowers yields on bonds and thereby fosters more

favorable financial conditions overall. This will allow the stimulus to pick up steam, support economic growth over the medium term, and allow inflation to rise."

(3) "Finally, policies that promise temporarily higher inflation following ZLB episodes can help generate a faster recovery and better sustain price stability over the longer run. In model simulations, these 'make-up' strategies can mitigate nearly all of the adverse effects of the ZLB."

William's PR department rushed to set the record straight with the *WSJ,* which reported after the market close: "New York Fed President John Williams didn't intend to suggest Thursday that the central bank might make a large interest rate cut this month, a spokesman said Thursday. In the speech, presented at an academic conference in New York, Mr. Williams said policy makers needed to confront potential weaknesses more quickly given the prospect that a historically low interest rate could fall to zero sooner, leaving less room to stimulate growth in a downturn."

Williams ended his speech by saying that the actions he recommended "should vaccinate the economy and protect it from the more insidious disease of too low inflation." Raise your hands if you agree that "too low inflation" is an "insidious disease."

Also weighing in a Fox Business Network interview on Thursday with a similar let's-ease-before-we-have-to message was Fed Vice Chair Richard Clarida: "You don't need to wait until things get so bad to have a dramatic series of rate cuts," he said. "We need to make a decision based on where we think the economy may be heading and, importantly, where the risks to the economy are lined up."

Let the easing begin!

CALENDARS

US. Mon: Chicago Fed National Activity Index 0.1. **Tues:** Existing Home Sales 5.34mu, FHFA House Price Index 0.3%, Richmond Fed Manufacturing Index 5. (DailyFX estimates)

Global. Mon: Kuroda. **Tues:** Eurozone Consumer Confidence -7.2, Japan Machine Tool Orders. (DailyFX estimates)

STRATEGY INDICATORS

Global Stock Markets Performance (*link*): Last week saw the US MSCI index drop 1.2% from its record high and record its biggest decline in seven weeks. The AC World ex-US was unchanged for the week and remained 12.9% below its record high in January 2018. The US MSCI's weekly performance ranked 40th among the 49 global stock markets we follow in a week when 24/49 countries rose in US dollar terms. That compares to the prior week's 8/49 ranking, when the US MSCI rose 0.8% as 19 markets rose. EM Asia was the best-performing region last week with a gain of 0.9%, followed by BRIC (0.4%). The regions underperforming last week: EM Eastern Europe (-1.5), EM Latin America (-0.9), EMU (-0.6), EMEA (-0.2), and EAFE (-0.1). Turkey was the best-performing country with a gain of 6.6%, followed by Hungary (3.1), Sri Lanka (2.7), Belgium (2.6), and the Czech Republic (2.6). Of the 25 countries that underperformed the AC World ex-US MSCI last week, Argentina fared the worst, falling 6.6%, followed by Italy (-2.8), Russia (-2.7), and Israel (-2.3). The US MSCI's ytd ranking fell four places last week to 11/49, with its 19.1% ytd gain still well ahead of that of the AC World ex-US (11.6). All regions and 44/49 countries are in positive territory ytd. Nearly all the regions are outperforming the AC World ex-US ytd: EM Eastern Europe (17.2), EM Latin America (13.6), BRIC (12.6), EMU (12.3), and EMEA (12.0). EM Asia (8.4) is the biggest laggard ytd, and the ytd performance of EAFE (11.6) matches that of the AC World ex-US. The best country performers ytd: New Zealand (26.1), Greece

(25.8), Russia (24.6), Colombia (24.5), and Argentina (24.0). The worst-performing countries so far in 2019: Pakistan (-16.8), Chile (-4.7), Sri Lanka (-2.5), Jordan (-2.1), and Malaysia (-0.3).

S&P 1500/500/400/600 Performance (*link*): All of these indexes fell for the first time in seven weeks, but dropped by nearly equal amounts. MidCap's 1.2% decrease was slightly lower than the declines for LargeCap (-1.2%) and SmallCap (-1.3). LargeCap ended the week 1.3% below Monday's record high, and MidCap weakened to 5.5% below its 8/29 record high. SmallCap remained in a correction at 14.4% below its 8/29 record after narrowly averting a bear market at the end of May. Just four of the 33 sectors moved higher last week compared to 13 rising a week earlier. Last week's best performers: SmallCap Utilities (1.0), MidCap Materials (0.4), LargeCap Consumer Staples (0.2), and LargeCap Materials (0.2). MidCap Energy (-8.3) was the biggest decliner, followed by SmallCap Energy (-6.9), LargeCap Communication Services (-3.1), and LargeCap Energy (-2.7). In terms of 2019's ytd performance, all three indexes are still off to a healthy start for the year. LargeCap leads with a gain of 18.7% ytd, just 2.2ppts ahead of MidCap (16.5) and well ahead of SmallCap (11.3). Thirty-one of the 33 sectors are positive ytd, with the cyclicals leading the top performers: LargeCap Tech (30.0), MidCap Tech (26.7), LargeCap Consumer Discretionary (24.1), MidCap Industrials (22.2), and LargeCap Industrials (20.3). MidCap Energy (-10.6) is the biggest decliner so far in 2019, followed by these underperformers: SmallCap Energy (-8.5), SmallCap Consumer Staples (3.5), LargeCap Health Care (6.0), and MidCap Consumer Staples (6.0).

S&P 500 Sectors and Industries Performance (*link*): Just two of the 11 S&P 500 sectors rose last week as five outperformed the S&P 500's 1.2% decline. That compares to seven rising a week earlier, when six outperformed the S&P 500's 0.3% decline. Consumer Staples and Materials were the best-performing sectors, with gains of 0.2%, ahead of Utilities (-0.4%), Tech (-0.7), and Health Care (-0.8). Last week's biggest underperformers: Communication Services (-3.1), Energy (-2.7), Real Estate (-2.3), Consumer Discretionary (-1.7), Financials (-1.3), and Industrials (-1.2). All 11 sectors are higher so far in 2019, compared to just two sectors rising during 2018, when the S&P 500 fell 6.3%. These five sectors have outperformed the S&P 500's 18.7% rise ytd: Information Technology (30.0), Consumer Discretionary (24.1), Industrials (20.3), and Communication Services (19.3). The ytd laggards: Health Care (6.0), Energy (9.4), Utilities (14.0), Materials (15.8), Financials (17.1), Consumer Staples (18.3), and Real Estate (18.4).

Commodities Performance (*link*): Last week, the S&P GSCI index tumbled 4.3% for its biggest decline in seven weeks as nine of the 24 commodities moved higher. That compares to 19 rising a week earlier when the index fell 2.9%. The index had nearly climbed out of a correction during mid-April, with a drop of just 10.0% from its high in early October after being down as much as 26.9% from that high on 12/24. It's now 17.2% below its October high. Nickel was the strongest performer for the week, as it soared 9.4%, ahead of Lean Hogs (7.8%), Silver (6.3), and Lead (3.9). Natural Gas was the biggest decliner, with a drop of 8.5%, followed by Crude Oil (-7.5), Unleaded Gasoline (-6.8), and Brent Crude (-6.1). The S&P GSCI commodities index is up 11.1% ytd following a decline of 15.4% in 2018. The top-performing commodities so far in 2019: Nickel (38.3), Unleaded Gasoline (37.9), Lean Hogs (29.4), and Crude Oil (22.8). The biggest laggards in 2019: Natural Gas (-24.2), Cotton (-12.6), Live Cattle (-12.4), Kansas Wheat (-10.0), and Feeder Cattle (-4.7).

S&P 500 Technical Indicators (*link*): The S&P 500 price index fell 1.2% last week, but continued its successful test of its short-term 50-day moving average (50-dma) and its long-term 200-day moving average (200-dma) at the end of May. The index's 50-dma relative to its 200-dma rose for 22nd time in 23 weeks to a 15-month high, forming a Golden Cross for a 17th week after 16 weeks in a Death Cross formation. The index had been in a Golden Cross for 137 weeks through late November, and its previous Death Cross lasted for 17 weeks through April 2016 (when its 50-dma bottomed at a then-four-year low of 4.5% below its 200-dma in March 2016). The current Golden Cross reading of 4.4% is up from -5.2% in early February, which had matched the lowest reading since November 2011. It's still down from a 55-month high of 7.2% in February 2018. The S&P 500's 50-dma rose at a faster rate, but the price index dropped to 2.6% above its 50-dma from a 19-week high of 4.3% above a week earlier. That's up from a 22-week low of 4.2% below its falling 50-dma at the end of May, but down from 6.6% above during mid-February, which was its highest since October 2011. The 200-dma rose for a sixth week and at a faster pace too. It had been rising for 16 weeks through mid-May after falling from October to February in the first downtrend since May 2016 (when it had been slowly declining for nine months). The index traded above its 200-dma for a seventh week but dropped to 7.1% above its rising 200-dma from a 17-month high of 8.7% a week earlier. That compares to 14.5% below its falling 200-dma on 12/24, which was the lowest since April 2009 and remains well below the seven-year high of 13.5% above its rising 200-dma during January 2018.

S&P 500 Sectors Technical Indicators (*link*): Ten of the 11 S&P 500 sectors traded above their 50-dma, down from all 11 in the previous four weeks. Real Estate fell below its 50-dma in the latest week for the first time since mid-January. All 11 sectors had been below their 50-dma in early January. The longer-term picture—i.e., relative to 200-dmas—also shows 10 sectors trading above currently, down from 11 a week earlier. Energy moved back below its 200-dma after being above briefly a week earlier for the first time since early October. Ten sectors are in the Golden Cross club (with 50-dmas higher than 200-dmas), unchanged from a week earlier and matching the highest count since January 2018, when all 11 sectors were in the club. Energy is the sole laggard and has been out for 36 straight weeks. Ten of the 11 sectors have rising 50-dmas now, down from 11 a week earlier, as Energy turned back down again in the latest week. Ten sectors have rising 200-dmas, up from eight a week earlier, as Health Care and Industrials turned up in the latest week. Energy has had a mostly falling 200-dma for more than eight months. That compares to just two sectors with rising 200-dmas in early January, in what was then the lowest count since all 11 sectors had falling 200-dmas two years before.

US ECONOMIC INDICATORS

Leading Indicators (*link*): "As the US economy enters its eleventh year of expansion, the longest in US history, the LEI suggests growth is likely to remain slow in the second half of the year," according to Ataman Ozyildirim, senior director of Economic Research at The Conference Board. June's Leading Economic Index (LEI) fell for the first time this year, remaining stalled near its record high, showing little movement the past nine months. It dropped 0.3% in June after rising only 0.3% during the three months through May; it had climbed 4.3% the first nine months of 2018—averaging monthly gains of 0.5%. Last month, six components of the LEI contributed positively and four negatively—with the yield spread (-0.04ppt) contributing negatively for the first time since January 2008. Negative contributions were also posted by building permits (-0.18), ISM new orders diffusion index (-0.12), and jobless claims (-0.11). The biggest positive contributions were recorded by the leading credit index (0.12), average manufacturing workweek (0.07), stock prices (0.05), and consumer expectations (0.03), with real core capital goods orders and real consumer goods orders each contributing 0.1ppt. The LEI is up 1.6% y/y—the weakest since the end of 2016—slowing steadily from last September's 6.6%, which was the strongest since February 2011.

Coincident Indicators (*link*): The Coincident Economic Index (CEI) in June continued to reach new record highs, though the pace has slowed during the first half of this year. June saw the CEI tick up 0.1% after a 0.2% gain in May, following no growth the first four months of this year—advancing only 0.3% ytd. That made for the weakest six-month growth rate since May 2016, though the upticks in May and June were encouraging. The CEI is up 1.6% y/y, easing from 2.4% in January, and the slowest since February 2017. Three of the four components contributed positively to June's CEI; here's a look at the components: 1) Employment posted the largest contribution to June's CEI after being the smallest contributor to May's. Payroll employment climbed at a five-month high of 224,000 last month, bouncing back from May's subdued gain of 72,000—averaging 171,000 jobs per month during Q2. 2) Real personal income—excluding transfer payments—rebounded 0.8% during the three months ending June to a new record high, more than reversing the decline over the prior three-month period. 3) Real manufacturing & trade sales increased for the fifth time this year, up 0.1% in June and 1.0% ytd—to within 0.4% of March's record high. 4) Industrial production was neutral in June after being one of the top contributors to May's CEI. Industrial production in June was flat, as a 3.6% drop in utilities output offset gains in both manufacturing (0.4%) and mining (0.2) production last month. June's 0.4% increase in factory output followed a 0.2% advance in May—not a lot, though a promising sign after the 1.3% drop during the four months through April.

Regional M-PMIs (*link*): A tale of two regions: Both Fed districts that have reported on manufacturing activity for July so far—Philadelphia and New York—show activity moved from contraction to expansion, with Philadelphia's performance noteworthy. The composite (to 13.1 from -4.2) index revealed manufacturing activity grew at its fastest pace this year after dipping into negative territory in June for the first time since May 2016. Philadelphia's composite (21.8 from 0.3) index showed activity rebounded from a standstill in June to its best growth in 12 months in July, while activity in the New York (4.3 from -8.6) region paled in comparison, recovering 12.9 points, after plunging a record 26.4 points in June to its lowest reading since October 2016. New orders (8.7 from -1.9) are expanding again, though only in the Philadelphia (18.9 from 8.3) region, which showed the strongest increase in billings since January, while new orders in New York (-1.5 from -12.0) continued to contract, though at a slower pace. The employment (10.2 from 6.0) measure nearly doubled this month as manufacturers in the Philadelphia (30.0 from 15.4) region added to payrolls at the fastest pace since October 2017, while New York's (-9.6 from -3.5) cut payrolls at the fastest pace since January 2016.

Consumer Sentiment Index (*link*): Consumer sentiment was little changed in mid-July, remaining at fairly favorable levels since the start of 2017. Richard Curtin, director of the University of Michigan survey, noted that "variations in the Sentiment Index have been remarkably small, ranging from 91.2 to 101.4 the past 30 months." The Consumer Sentiment Index (CSI) ticked up to 98.4 in mid-July from 98.2 in June—holding within a 2.8-point range for the past five months. The expectations (to 90.1 from 89.3) index improved this month, after sliding 4.2 points last month, and is not far from May's 93.5 reading—which was the best since January 2004. Meanwhile, the present situation (111.1 from 111.9) index edged lower, remaining in a volatile flat trend below its cyclical high of 121.2 reached in March 2018. The report notes that the most interesting change in the July survey was in inflation expectations, with the one-year rate (2.6% from 2.7%) slightly lower, while the longer-term rate (2.6 from 2.3) moved to the top of the narrow 2.3% to 2.6% range it has followed in recent years. Meanwhile, the share of households that expected interest-rate increases fell to 44%—the lowest since May 2013—while 19% expected rates to fall, the most in 10 years.

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