



MORNING BRIEFING

July 24, 2019

Mark to Market

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

(1) The Boom-Bust Barometer is running out of room to boom. (2) There's no ceiling on forward earnings, which is in record-high territory. (3) Yet another record high for forward revenues. (4) Another hook up for quarterly earnings? (5) Using the Blue Angels as a valuation model. (6) Some moon shots in the fundamentals of selected retailers.

Strategy I: Limits of the Boom-Bust Barometer. In the past, Joe and I have often observed the strong correlation between the S&P 500 and our Boom-Bust Barometer (BBB), which is the ratio of the CRB raw industrials spot price index to initial unemployment claims ([Fig. 1](#)). They've diverged lately, as the S&P 500 is at yet another record high while the BBB has been fluctuating widely and wildly since late last year, though also in record-high territory. It's been near the bottom of this range recently.

The CRB component of the BBB has been mostly falling since mid-2018 ([Fig. 2](#)). It is down 15% from the 6/12/18 week through the 7/13 week of this year, hovering around its lowest readings since early April 2016. That reflects the weakness in the global economy.

On the other hand, jobless claims remain historically low, with the four-week average at 218,750 during the 7/13 week. The problem is that they probably can't go much lower, while commodity prices could do so if the global economy continues to weaken. Boosting commodity prices undoubtedly would require an amicable resolution of Trump's trade war with China.

Then again, there is nothing set in stone about the importance of the BBB to the S&P 500. Consider the following:

(1) *Forward earnings matter more.* In fact, the BBB has also been highly correlated with S&P 500 forward earnings, which clearly has a more direct impact on stock prices than our jerry-rigged ratio ([Fig. 3](#)). These two series also have diverged since late last year, with forward earnings climbing to a new record high in early July.

The strength in forward earnings suggests that industry analysts believe that their companies can continue to grow earnings despite the headline news about weaker global economic activity. Forward earnings tends to be an excellent year-ahead leading indicator of actual earnings with one important exception: Industry analysts never see recessions coming ([Fig. 4](#)). If you agree with us that a recession is unlikely over the next 12 months, then forward earnings are bullish for actual earnings and for stock prices.

(2) *Forward revenues at another record high.* Confirming the analysts' bullishness on earnings is their S&P 500 forward revenues estimate, which also rose to a record high during the 7/18 week ([Fig. 5](#)). Weekly forward revenues is a very good coincident indicator of actual quarterly S&P 500 revenues ([Fig. 6](#)).

(3) *Waiting for another hook up.* Meanwhile, the stock market continues to perform well. That's despite the fact that earnings growth was weak during Q1 and likely remained weak during Q2. There's no relief in sight until Q4 and next year. That confirms what we all should know: The stock market discounts the future, not the past or the present, except to the extent that they influence the future.

S&P 500 earnings rose just 2.8% y/y during Q1 ([Fig. 7](#)). The earnings blend of estimates/actuals for Q2 was expected to be -1.5% during the 7/18 week, up slightly from -2.0% during the previous week. We still expect a small positive growth rate for Q2 similar to Q1's result. Q3 may also be getting set up by the analysts for the typical upward earnings hook, as the latest estimated growth rate was cut to -0.2%.

Meanwhile, Q4 is expected to be up 6.6%, while all of 2020 is projected to show earnings growth of 10.5%, up from 2.5% this year ([Fig. 8](#)).

Strategy II: Valuation & the Blue Angels. Joe and I like to monitor the flight of the S&P 500 with our Blue Angels radar tracking system ([Fig. 9](#)). It shows S&P 500 forward earnings multiplied by forward P/Es of 10.0-19.0 in increments of 1.0. These 10 series fly in parallel formation, never colliding, just as the Blue Angels pilots of the US Navy do.

Then we show the S&P 500 as the stunt plane, flying in the vapor trail of the Blue Angels. So in one chart, we can see all three variables in the stock market identity $P = P/E \times E$, where "P" is the daily S&P 500 closing price, "P/E" is the forward valuation multiple, and "E" is forward earnings per share.

The current readings as of Friday's close were $P = 2976.61$, $P/E = 16.9$, and $E = \$176.27$. As long as there is no recession, earnings should continue to climb higher, continuing to lift "P" to new highs. Every now and then, the market may hit a P/E air pocket, as it has numerous times during the current bull market. We've counted 63 such air pockets and associated "panic attacks," which is a normal reaction when flying on a plane that suddenly and unexpectedly loses altitude.

The combined panic attacks at the start and end of 2018 caused the forward P/E to fall from a high of 18.6 on 1/23/18 to a low of 13.5 on 12/24/18 ([Fig. 10](#)). It was back to 16.9 at the end of last week.

It is widely known that the historical average P/E of the stock market tends to be around 15.0. Let's use that to simplify the Blue Angels analysis. We can compare the actual S&P 500 to its Blue Angel series based on forward earnings times 15.0 ([Fig. 11](#)). We can then calculate percentage difference between the two. When the divergence is positive (with the S&P 500 exceeding its implied value based on a 15.0 P/E), stocks presumably are overvalued. A

negative reading suggests stock are undervalued ([Fig. 12](#)).

Based on this simple model, the S&P 500 is currently overvalued by 12.9%—not by much. However, 15.0 is just the average P/E. As we've discussed over the past few days, the P/E should be above average in an economic environment like the current one, where inflation and interest rates are well below average. Granted, economic growth is also below average. But having all those variables at moderate levels simply increases the likelihood that the economic expansion will be sustained, which would also argue for a higher-than-average P/E.

Strategy III: Retail Forward Revenues & Earnings on Moon Shots. One of our lazy-days-of-summer projects has been to track the relationship between the forward revenues and earnings of various S&P 500 industries and the relevant economic variables that pertain to those industries. So far, among the most remarkable charts are those reminiscent of the Apollo 11 moon shot, which occurred 50 years ago. Let's focus on what we have found out so far for retailers:

(1) *Internet retail (Amazon, Booking Holdings, eBay, and Expedia)*. Needless to say, the Internet & Direct Marketing Retail industry index has gone beyond the moon and seems to be heading to Mars or beyond. The forward revenues of the industry has doubled since August 2015, while forward earnings has doubled since April 2018 ([Fig. 13](#) and [Fig. 14](#)). Online retail sales has doubled since October 2012 from \$335 billion (saar) to \$678 billion currently.

(2) *Home Improvement (Home Depot and Lowe's)*. The forward revenues of the Home Improvement industry has doubled since February 2013 ([Fig. 15](#)). Over that same period, retail sales of building materials and garden equipment rose 26%. The forward earnings of the industry has doubled since December 2014 ([Fig. 16](#)).

(3) *Restaurants (Chipotle, Darden, McDonald's, Starbucks, and Yum!)*. After stalling from mid-2014 through late 2017, forward revenues of the Restaurants industry is up 19% since the start of 2018 ([Fig. 17](#)). Retail sales of food services and drinking places is up 9% from January 2018 through June 2019. The industry's forward earnings has been on a tear since the start of 2015, rising 61% since then ([Fig. 18](#)).

We automatically update these charts and other retail-related ones in our [Industry Indicators: Retail](#) publication.

CALENDARS

US. Wed: M-PMI & NM-PMI Flash Estimates 51.0/51.8, New Home Sales 658k, MBA Mortgage Applications, DOE Crude Oil Inventories. **Thurs:** Durable Goods Orders Total and Ex Transportation 0.7%/0.2%, Advance Merchandise Trade Balance -\$72.2b, Kansas City Fed Manufacturing Index 2, Jobless Claims 217k, Wholesale Inventories 0.4%. (DailyFX estimates)

Global. Wed: Eurozone, Germany, and France C-PMI Flash Estimates 52.1/52.3/52.5, Eurozone, Germany, and France M-PMI Flash Estimates 47.6/45.2/51.6, Eurozone, Germany, and France NM-PMI Flash Estimates 53.3/55.2/52.8, Japan M-PMI Flash Estimates. **Thurs:**

Germany Ifo Business Climate, Current Assessment, and Expectations Indexes 97.0/100.4/94.0, Japan CPI Headline, Core, and Core-Core 1.0%/0.8%/0.7% y/y, ECB Rate Decision 0.00%, ECB Marginal Lending Facility and Deposit Facility Rates 0.25%/-0.40%, Draghi, Lowe. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Q2 Earnings Season Monitor ([link](#)): With the Q2 earnings season 21% 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 earnings growth is higher. The rest of the surprise and growth metrics are about the same as Q1, but these figures will continue to change as more Q2-2019 results are reported in the coming weeks. Of the 105 S&P 500 companies that have reported through midday Tuesday, 79% exceeded industry analysts' earnings estimates. Collectively, these reporters have averaged a y/y earnings gain of 7.5%, and exceeded forecasts by an average of 5.6%. On the revenue side, 65% of companies beat their Q2 sales estimates so far, with results coming in 0.9% above forecast and 3.9% higher than a year earlier. Q2 earnings growth results are positive y/y for 71% of companies, versus a similar 71% at the same point in Q1, and Q2 revenues have risen y/y for 71% versus an also similar 71% during Q1. Looking at earnings during the same point in the Q1-2018 reporting period, a similar percentage of companies (79%) in the S&P 500 had beaten consensus earnings estimates by a slightly higher 5.8%, and earnings were up a lower 5.0% y/y. With respect to revenues at this point in the Q1 season, a sharply lower 52% had exceeded revenue forecasts by a slightly lower 0.7%, but sales rose a slightly higher 4.0% y/y. These early readings for Q2 indicate a continuation of a marked slowdown in revenue and earnings growth and a slight deterioration in profit margins compared to 2018's stellar results. 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. As more companies report, it's looking less possible that Q2-2019 will make the sixth.

S&P 500 Sectors Net Earnings Revisions ([link](#)): The S&P 500's NERI weakened for a second straight month in July and was negative for the first time in three months. The index's brief positive NERI streak comes on the heels of a six-month negative NERI streak from November to April. That had followed 18 months of positive readings, which had been its longest positive streak since a 26-month string ending August 2011. NERI fell to -2.4% in July from 0.1% in June, which compares to a record high of 22.1% in March 2018. NERI improved m/m for three of the 11 sectors; that compares to six improving in June and all 11 improving in May, which was the first time that had happened since January 2018. NERI was positive for 3/11 sectors, down from five in June, which compares to negative readings for all 11 sectors from February to April. Energy and Tech's NERI turned negative in July for the first time in three months. Materials has the worst track record, with 10 months of negative NERI, followed by Communication Services (9) and Industrials (9). Here are the sectors' July NERIs compared with their June readings: Health Care (9.0% in July, down from 9.1% in June), Real Estate (6.9 [24-month high], 4.9), Consumer Staples (2.6 [15-month high], 0.9), Tech (-1.3, 0.8), Communication Services (-1.8, -0.5), Consumer Discretionary (-2.7, -2.3), Utilities (-3.4 [35-

month low], -1.5), Industrials (-3.9, -2.8), Financials (-9.1, -1.0), Energy (-10.3, 2.7), and Materials (-11.9, -12.1).

S&P 500 Earnings, Revenues, Valuation & Margins ([link](#)): Consensus S&P 500 forward revenues and earnings edged down slightly w/w from their record highs. Analysts expect forward revenues growth of 5.2% and forward earnings growth of 7.6%, with the earnings metric down 0.2ppt 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 9.3ppts 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 2.5% in 2019 before improving to 10.5% 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 11.9% in 2018 to 11.7% in 2019 before rising to 12.3% in 2020. The S&P 500's forward P/E of 17.1 was unchanged w/w, and down from a 14-month high of 17.2 in early July. 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 2.07 was also steady w/w, but down from a 10-month high of 2.08 in early July. 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. 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 3/11 sectors: Consumer Discretionary, Financials, and Industrials. 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, including five sectors in the latest week. 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 (18.5, down from 19.2), Real Estate (15.8, down from 17.0), Communication Services (14.8, down from 15.4), Utilities (12.9, down from its record high of 13.0 in May), S&P 500 (12.1, down from 12.4), Materials (10.2, 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 (7.1, down from 8.0).

US ECONOMIC INDICATORS

Existing Home Sales ([link](#)): Existing home sales in June continued their up-and-down pattern, falling for the third time this year (running at a pace similar to 2015 levels), with housing shortages a major headwind. Existing-home sales—tabulated when a purchase contract closes—dropped 1.7% to 5.27mu (saar) after a 2.9% increase in May and no change in April. Year to date, sales are up 5.4%, thanks to February's 11.2% spike to its best level in nearly a year. Regionally, sales rose in two regions and fell in two, though all were below year-ago levels; here's a look: Midwest (1.6% m/n & -1.6% y/y), Northeast (1.5 & -4.2), South (-3.4 & -0.4), and West (-3.5 & -5.2). Single-family sales sank 1.5% last month to 4.69mu (saar) after rising 2.8% and falling 0.9% the previous two months. Multi-family sales declined 3.3% to 580,000 units (saar) in June after a two-month spurt of 11.1%. Both single-family (-1.7% y/y) and multi-family (-6.5) sales remained below a year ago, though the yearly change in the former looks likely soon to turn positive. Meanwhile, the number of single-family homes on the market at the end of June increased to 1.71 million, though were slightly below year-ago levels, while the months' supply (4.4) remains near historical lows. While Yun notes the nation is in the midst of a housing shortage, he also observes that other factors could be contributing to the low number of sales, "Either a strong pent-up demand will show in the upcoming months, or there is a lack of confidence that is keeping buyers from this major expenditure. It's too soon to know how much of a pullback is related to the reduction in the homeowner tax incentive."

Regional M-PMIs ([link](#)): Three Fed districts that have reported on manufacturing activity for July so far—Philadelphia, New York, and Richmond—show activity moved from contraction to expansion, with the Philadelphia region accounting for the move up. The composite (to 4.7 from -2.1) index shows manufacturing activity expanding this month, albeit at a slow pace, after dipping into negative territory in June for the first time since August 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. Meanwhile, Richmond's composite (-12 from 2) shows growth in that region contracting at its fastest pace since January 2013. The new orders (-0.2 from -1.9) gauge showed billings at a virtual standstill, as the strongest growth in Philadelphia orders (18.9 from 8.3) in a year offset negative readings in both New York (-1.5 from -12.0) and Richmond (-18 from -2) billings—with latter's the weakest in 6.5 years. Meanwhile, the employment (5.8 from 5.3) measure matched June's pace as manufacturers in the Philadelphia (30.0 from 15.4) region added to payrolls at their fastest pace since October 2017, more than offsetting job cuts in both the Richmond (-3 from 4) and New York (-9.6 from -3.5) regions.

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