



MORNING BRIEFING

August 20, 2019

Searching for Growth

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

(1) Weekly S&P 500 forward revenues remain impressive, still making new highs. (2) No recession in quarterly S&P 500 revenues, which also rose to new high during Q2. (3) Corporate managers managing to find solid revenues growth in slow-growing global economy. (4) Small spread between growth rates in aggregate and per-share revenues. (5) Lots of cyclically weak growth indicators. Are they nearing bottoms? (6) Intermodal railcar traffic is in a recession. (7) Soft patch for earnings, or just tough y/y comps? (8) Forward earnings at record high. (9) Doing the math on S&P 500 targets.

Strategy I: S&P 500 Delivers Record Revenues. Both last year and this year, Joe and I have been impressed by S&P 500 forward revenues. The weekly series, which is a time-weighted average of analysts' consensus expectations for S&P 500 actual revenues this year and next year, has been rising to record highs ([Fig. 1](#)). It dipped at the end of last year but has bounced back smartly this year. We've been impressed because it has contradicted the grim headline news about the sorry state of the global economy, which is still growing but at a very slow pace.

Just as impressive is that the weekly series continues to be a very good coincident indicator of the actual quarterly data for revenues, as evidenced by the S&P 500's Q2 results released by Standard & Poor's at the end of last week. Revenues rose 5.0% y/y to a new record high ([Fig. 2](#)). There's no recession in the quarterly revenues data. There was a brief recession from Q1-2015 through Q1-2016 when plunging commodity prices caused a global growth recession. But it has been solid growth since then.

This suggests to us that as long as US real GDP continues to grow around 2.0% and global growth remains subpar, but positive, the folks who manage America's biggest companies will continue to manage to achieve positive low-single-digits revenues growth. If they can maintain their historically high profit margins, which we expect they will, then earnings growth should be close to revenues growth. Of course, if a recession unfolds, revenues growth will be negative no matter how good S&P 500 managers might be at running their businesses in a slow-growing world.

The spread between the growth rates of revenues on an aggregate and a per-share basis has been relatively small considering all the hype about the big positive impact of stock buybacks on per-share results. During Q2, the former was up 2.9% while the latter was up 5.0% ([Fig. 3](#)). That's a relatively small spread despite record S&P 500 buybacks of \$823 billion over the four quarters ended Q1 ([Fig. 4](#)). (See our [Topical Study #84](#) titled "Stock Buybacks: The True Story.")

With the exception of forward revenues, many of the economic indicators that we use to forecast S&P 500 aggregate revenues growth have been weak. Let's review the relevant data:

(1) *Business sales*. The growth rate in the Census Bureau's measure of manufacturing and trade sales tends to be highly correlated with the growth rate of S&P 500 aggregate revenues. The fit between the two is remarkably good given that the former includes only goods and not services. The former increased just 1.3% y/y through June, while the latter increased 2.9% during Q2 ([Fig. 5](#)). Both saw growth in the high single digits during 2017 and the first half of 2018, when the global economy recovered from its 2015-16 growth recession. So comps have been trougher in recent quarters. They should get easier over the rest of this year and into next. We expect both sales measures to grow at around a 5% clip over the next year and a half.

(2) *Factory orders*. New factory orders have been especially weak, at -1.2% y/y through June ([Fig. 6](#)). Growth in these orders has been deteriorating since early this year, dipping into negative territory during May for the first time since November 2016. Since S&P 500 aggregate revenues tends to trail factory orders (both on a y/y basis), the recent weakness in orders may weigh on revenues over the rest of the year.

(3) *Merchandise exports*. Trump's escalating trade war with China has depressed the growth in US merchandise exports so far this year. These exports fell -3.6% y/y during June ([Fig. 7](#)). US merchandise exports account for only 8% of nominal GDP. The good news is that domestic demand for goods and services remains strong, led by consumer spending.

(4) *Purchasing Managers Index and industrial production*. The US M-PMI has been weakening all year but has remained north of 50.0, at 51.2 in July ([Fig. 8](#)). It is down from a recent peak of 60.8 last August, which was near previous cyclical highs for this series. Corresponding with the weakening in the US-PMI, the growth in US industrial production has run out of steam, with a gain of just 0.5% y/y during July ([Fig. 9](#)).

(5) *Railcar traffic*. Intermodal railcar loadings have been very weak this year so far. To smooth out this volatile series, Debbie and I use its 26-week average, which was down -3.9% through the 8/10 week ([Fig. 10](#)). We think that reflects the weakness in exports and imports resulting from US-China trade tensions. This is the weakest indicator of the ones we are highlighting today. The good news is that this series isn't as highly correlated with S&P 500 aggregate revenues as the other indicators discussed above.

Earnings growth trailed revenues growth during Q2-2019 for a second straight quarter, and for the first time since Q2-2016. Counting Q2-2019, earnings growth has trailed revenue growth just six times in the 42 quarters since the bull market started more than 10 years ago. It also happened during Q1- and Q2-2016 and Q1- and Q2-2009.

Strategy II: Soft Patch for Earnings or Tough Comps? The S&P 500 profit margin upticked to 11.8% during Q2, but it was down from 12.3% a year ago ([Fig. 11](#)). As a result, S&P 500 operating earnings rose just 0.7% y/y during the quarter ([Fig. 12](#) and [Fig. 13](#)). That followed a

small increase of 2.8% during Q1.

This is the weakest performance since 2015 and 2016, when comparisons turned slightly negative during four consecutive quarters. The current earnings growth recession is less severe and is partially attributable to tough comps as a result of the corporate tax cut that boosted earnings last year. So we view it more as a soft patch than as a growth recession.

Now let's review the analysts' earnings expectations for the rest of this year and all of next year, and compare them to our forecasts:

(1) *Quarterly outlook.* Consensus analysts' earnings estimates for the 8/15 week show a -2.2% y/y decline for Q3 followed by a 4.8% increase during Q4 ([Fig. 14](#)). That is well below where analysts had pegged both growth rates last fall, at over 10%. Q3 results should beat expectations, as results for Q1 and Q2 did.

Upside "earnings hooks" are the norm during earnings seasons because analysts experience mood swings from excessive optimism about distant earnings prospects, which tend to turn excessively pessimistic as earnings seasons approach for any particular quarter. Analysts forecasted negative y/y earnings growth for Q1 and Q2 just before each respective quarter, but neither quarter's results actually fell below zero. We anticipate a similar "hook" for the Q3 based on recent history. Past history also shows that analysts tend to base their estimates on management guidance—which tends to be overly conservative heading into earnings season, making managements' forecasts easier to beat.

(2) *2019 and 2020 outlook.* For the full year of 2019, analysts expect S&P 500 operating annual earnings to grow a meager 2.1% while 2020 growth is expected to pick up to 10.4%. Keep in mind that 2020 growth comparisons will be easier than those of 2019, which followed 2018's tax-cut-boosted 23.8% growth ([Fig. 15](#)). Operating earnings growth expectations for 2020 have dropped some since earlier this year but remain in record-high territory ([Fig. 16](#)).

(3) *Forward earnings.* Forward earnings, the time-weighted average of consensus operating earnings estimates for the current and next year, rose to a new record high of \$176.69 per share during the 8/15 week. It is converging toward the 2020 consensus estimate, which is currently \$183.61 ([Fig. 17](#) and [Fig. 18](#)).

Strategy III: Doing the Math on S&P 500 Targets. Our targets for the S&P 500 remain at 3100 for this year and 3500 for next year. We can reverse-engineer them to determine the path for earnings required to hit bullseyes. Joe and I believe that given that both inflation and interest rates are below 2.0%, a forward P/E of 18.0 is doable and reasonable.

That means that 3100 by year-end would require the market to discount 2020 earnings per share of \$172. That's very reasonable given that we are projecting 2020 earnings at \$176, while the consensus of industry analysts is currently at \$184! There is plenty of margin for downside earnings revisions in this scenario, with 3100 still working out by the end of this year.

Getting to 3500 by the end of 2020 with an 18.0 forward P/E would require that the consensus

earnings-per-share estimate for 2021 be \$194. Joe and I are currently projecting that it will be \$185, or 5% above our \$176 estimate for next year, which is 5% above our 2019 estimate.

So while 3100 looks reasonable for this year, 3500 seems to be a stretch. However, keep in mind that the market discounts analysts' consensus expectations for the coming 12 months, and they tend to be too optimistic. That consensus could very easily be \$194 for 2021 by the end of next year. If analysts are forced to lower their estimates during 2021, as is likely, the market could still move higher as 2022 approaches.

Of course, this all assumes, as we do, that there will be no recession through at least the end of next year.

CALENDARS

US. Tues: Quarles. **Wed:** Existing Home Sales 5.40mu, MBA Mortgage Applications, DOE Crude Oil Inventories, FOMC Meeting Minutes (7/31). (DailyFX estimates)

Global. Tues: RBA Minutes of August Policy Meeting. **Wed:** Canada Headline & Core CPI 1.7%/1.8% y/y. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings rose simultaneously for all three indexes for the first time in seven weeks, remaining in the uptrends that began during March. LargeCap's has risen during 22 of the past 27 weeks, MidCap's 15 of the past 23 weeks, and SmallCap's 12 of the past 21 weeks. LargeCap's is back up to a record high, while MidCap's and SmallCap's improved to 1.2% and 6.3% below their mid-October highs. At their bottoms earlier in 2019, LargeCap's forward EPS had been the most below its record high since June 2016, and MidCap's was the lowest since May 2015. SmallCap's had not been this far below since October 2010. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act but began to tumble in October as y/y comparisons became more difficult. In the latest week, the rate of change in LargeCap's forward earnings edged up to 2.3% y/y from a 34-month low of 2.4%. That's down from 23.2% in mid-September, which was the highest since January 2011. MidCap's y/y change improved to 1.4% from a 40-month low of 1.2%, which compares to 24.1% in mid-September (the highest since April 2011). SmallCap's -4.2% y/y change is the lowest since December 2009. That compares to an eight-year high of 35.3% in early October. Analysts had been expecting double-digit percentage earnings growth for 2019 last October, but those forecasts are down substantially since then. Here are the latest consensus earnings growth rates for 2018, 2019, and 2020: LargeCap (22.7%, 1.7%, 11.5%), MidCap (22.7, -1.1, 14.1), and SmallCap (22.4, 0.0, 17.8).

S&P 500/400/600 Valuation ([link](#)): Valuations edged down across the board last week to 11-week lows for these three S&P market-cap indexes. LargeCap's forward P/E fell 0.2pt w/w to 16.3 and is down 0.9pt from a 17-month high of 17.2 at the end of July. That compares to a five-year low of 13.9 during December and a 16-year high of 18.6 during January 2018—and

of course is well below the tech-bubble record high of 25.7 in July 1999. Last week's level remains above the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's forward P/E dropped 0.3pt to 15.2, down from a 12-week high of 16.0 at the end of July. That's also down from a seven-month high of 16.3 in early April, but up from 13.0 during December, which was the lowest reading since November 2011. MidCap's P/E is down from a 15-year high of 19.2 in February 2017 and the record high of 20.6 in January 2002. However, MidCap's P/E has been at or below LargeCap's P/E for most of the time since August 2017—the first time that alignment has prevailed since 2009. SmallCap's P/E dropped 0.2pt w/w to 16.0, which compares to an 11-week high of 16.7 at the end of July. That's still well above its seven-year low of 13.6 during December and compares to its 15-year high of 20.5 in December 2016, when Energy's earnings were depressed. SmallCap's P/E was below LargeCap's P/E for an 11th straight week, after being below for much of December for the first time since 2003.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): With the Q2 earnings season more than 90% complete and mostly awaiting July-quarterly results, the earnings hook continued to rise in the latest week. The S&P 500's blended Q2-2019 EPS forecast rose 5 cents w/w to \$41.30. That represents an earnings gain of 0.7% y/y compared to the prior week's forecasted earnings gain of 0.6%. That's above our forecast of \$41.00 for Q2 EPS and flat earnings y/y. On a pro forma basis, the blended Q2 earnings growth rate is 2.9% y/y, which would be the 12th straight y/y rise and compares to 1.6% in Q1, 16.9% in Q4, and 28.4% in Q3 (which marked the peak of the current earnings cycle). Seven of the 11 sectors have recorded positive y/y earnings growth in Q2-2019, with only three rising at a double-digit percentage rate. That compares to six positive during Q1, when just one rose at a double-digit percentage rate. Just four sectors are beating the S&P 500's Q2 growth rate, down from five during Q1. Communication Services, Financials, and Materials are the only sectors to post better (or less worse) growth on a q/q basis during Q2. Looking ahead to the future, analysts as usual are trimming their forecasts for the next quarter. The S&P 500's Q3-2019 EPS forecast dropped 11 cents w/w to \$41.71. The consensus' \$41.71 estimate is down 3.0% in the six weeks since the start of the quarter, which now represents an earnings decline of 2.2% y/y. On a pro forma basis, the consensus Q3 estimate represents an earnings decline of 1.6% y/y and a 0.1% drop y/y ex-Energy. That compares to ex-Energy gains of 3.6% in Q2 and 3.0% in Q1, and is well below the 14.2% y/y gain in Q4-2018. Drilling down to the sector level, six are expected to record positive y/y growth, with seven beating the S&P 500, but only three are expect to improve q/q. Here are the latest Q3-2019 earnings growth rates versus their nearly final Q2-2019 growth rates: Financials (4.7% in Q3-2019 versus 10.0% in Q2-2019), Real Estate (3.6, 4.0), Health Care (2.5, 10.2), Utilities (2.0, 1.1), Industrials (1.8, -9.1), Consumer Discretionary (1.4, 0.9), Consumer Staples (-0.2, 1.4), Communication Services (-0.3, 17.7), Information Technology (-7.7, -2.8), Materials (-9.4, -13.1), and Energy (-23.4, -9.0).

US ECONOMIC INDICATORS

Housing Starts & Building Permits ([link](#)): Housing starts contracted for the third straight month in July, though building permits shot up to its highest reading this year. Meanwhile, homebuilders' optimism continues to improve. Housing starts sank 4.0% in July, and 6.2% the past three months, to a five-month low of 1.191mu (saar), driven by volatile multi-family units. Single-family starts rose for the fifth time this year, by 1.3% in July and 7.6% ytd, to 876,000

units (saar). Multi-family starts have plummeted 30.0% the past two months, to a 23-month low of 315,000 units (saar), following a four-month surge of 38.5%; these starts are down 4.0% ytd. Housing permits jumped 8.4% in July to 1.336mu (saar)—its biggest monthly increase since June 2017, though is showing no gain ytd, on a slump in multi-family structures. Since bottoming in April, single-family permits have jumped 6.6% to 838,000 units (saar), more than reversing declines the first four months of this year—showing a 1.3% ytd gain. Meanwhile, multi-family permits soared 21.8% last month to 498,000 units (saar), though were still down 2.7% ytd. The National Association of Home Builders Housing Market Index (HMI) for August shows homebuilders' confidence rose for the sixth time this year (to 66 from 56 in December), with two of the three components trending higher through the first eight months of this year: current sales conditions (73 from 61) and buyer traffic (50 from 43). The third component, expected sales conditions (70 from 61) remains considerably higher than in December, though has moved sideways in recent months—retaining its recent move up.

GLOBAL ECONOMIC INDICATORS

Eurozone CPI (*link*): July's CPI rate remained below 2.0% for the ninth consecutive month, while the core rate moved back below 1.0%. The headline rate slipped from 1.3% to 1.0% last month—a tick below the flash estimate of 1.1%—and the lowest rate since November 2016. It was at a recent peak of 2.3% last October. Looking at the main components, food, alcohol & tobacco (to 1.9% from 1.6% y/y) had the highest rate, followed by services (1.2 from 1.6)—though the former is accelerating, while the latter is decelerating. Non-energy industrial goods (0.4 from 0.3) had the lowest rate, continuing to hover just above zero. Meanwhile, the rate for energy (0.5 from 1.7) is heading toward zero, slowing steadily from 5.3% in March/April. The core rate—which excludes energy, food, alcohol, and tobacco—slowed to 0.9% (matching its flash estimate) after accelerating from 0.8% to 1.1% in June. Of the top four Eurozone economies, rates for France (1.3% y/y) and Germany (1.1) were above July's 1.0% headline rate, while rates in Spain (0.6) and Italy (0.3) were below. Portugal's rate was the weakest, falling 0.7% y/y—its first negative reading since February 2015.

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