Yardeni Research

MORNING BRIEFING
September 19, 2019

From Downhill to Uphill

See the collection of the individual charts linked below.

(1) Railroads' uphill climb. (2) Tariffs, end of margin gains, competition from truckers, and market disruption from (who else?) Amazon et al. throw rails off track. (3) Doing the Valuation Shuffle. (4) Stagnant S&P 500 P/E belies much churn among its sectors. (5) Value and Growth stocks have been mixing things up too, with Value outperforming Growth for a change. (6) Tossing stablecoin concept around, with vocal supporters and detractors.

Railroads: Profit-Margin Ride Over? After chugging along nicely for the better part of the past three years, railroad stocks are facing multiple challenges that could stop them in their tracks.

First and foremost, the US-China trade war is hurting the industry. The high-level spat has sent sales of US agricultural products and other items to China tumbling. Less trade and a US manufacturing slowdown have hurt the rails both directly (reducing business) and indirectly (making truckers, who are facing slower growth, tougher competitors). In addition, the industry may have squeezed all the savings possible out of an efficiency program rolled out in recent years, according to a well-thought-out article in *Barron's* last weekend.

The S&P 500 Railroad stock price index has climbed 1,736% since bottoming in 2000, outperforming the S&P 500's 121% gain, but it has been idling since its peak in May (*Fig. 1*). A resolution to the trade war would go far in getting the industry's stock price index back on track.

Here's what Jackie has discovered about the issues rails are facing:

(1) *Trade woes*. Transporting goods from the Heartland to the coasts for export is big business for railroad operators, so the US-China tariff spat is bad news for rail business. The tariffs also have hurt the industrial customers of railroad operators.

Railcar loadings have fallen 5.8% from the peak in early November 2018, based on the 26-week moving average to smooth out some of the seasonality in the data (*Fig. 2*). The tariff's impact is even more directly felt by the rails' intermodal traffic (transport of containers that fit on trains, trucks, and ships, and are often used to ship items abroad). Intermodal traffic, which represents 51% of railroads' business, is down 7.0% from its late December peak (*Fig. 3*).

On a y/y basis, intermodal railcar loadings have dropped 4.1% (*Fig. 4*). Over the past 19 years, that figure has been negative only twice, in 2009 and 2016.

According to the Association of American Railroads, the carloads that have fallen the most ytd through the week of 9/7 include coal (-6.6%), grain (-5.1), metallic ores and metals (-5.0), nonmetallic minerals (-4.7), and forest products (-4.2). Shipments of coal have been in long-term decline, as more utilities have been opting to use low-cost, cleaner-burning natural gas.

(2) *More competition from truckers***.** The trucking industry has also felt the pain of the US-China trade war and the resulting decline of international trade. The timing of the slowdown is unfortunate because many new medium- and heavy-weight trucks were delivered at the end of last year and early in 2019 (*Fig. 5*).

Total truck-hauling volumes remain at record absolute levels, but their growth slowed to a 3.8% y/y increase in July, based on the three-month average, compared to the peak growth of 8.4% last year (*Fig. 6* and *Fig. 7*). The softness in the trucking market is apparent in hauling prices, which aren't rising as sharply as last year. Prices for truck transportation of freight in the Producer Price Index rose only 1.2% y/y in August, compared to the peak of 8.2% y/y last October (*Fig. 8*).

(3) *End of efficiency gains?* In a 9/13 *Barron's* article, Bill Alpert questioned whether the railroads would be able to continue improving efficiency and lowering costs by using precision scheduled railroading, or PSR. He wrote: "Precision railroading involves replacing a rail network's traditional hub-and-spoke routes with straight runs, while keeping trains to strict schedules. By pulling longer trains using fewer locomotives, workers, and switch yards, CSX expanded its operating profit margin to 40% in 2018 from 30% in 2016."

The implied profit margin suggested by analysts' consensus revenue and earnings estimates for S&P 500 Railroads stands at 28.4%, a record high. About 4ppts of the 7ppt improvement since the beginning of 2018 reflects President Trump's tax cut for corporations, but the industry's margins had been gradually improving from a low of 8.5% in 2004 (*Fig. 9*).

Improving margins undoubtably have boosted earnings over the past three years. That's why it's notable that the industry suffered two back-to-back months of negative net earnings estimate revisions in July (-17.4%) and August (-32.0) (*Fig. 10*). Yet despite the downward revisions, analysts continue to call for the industry's earnings to rise by 11.2% this year and 12.1% in 2020 (*Fig. 11*). Stock investors are clearly more concerned about the Railroad industry, as its forward P/E has fallen to 16.5 from a post-tax cut peak of 18.7 in September 2018 (*Fig. 12*).

(4) *Tech-disruption watch.* Traditional players in the transportation industry should keep an eye on the moves tech giants are making. Amazon now delivers almost 50% of its own packages (accounting for 20% of all e-commerce shipments), up from about 15% two years ago, per a 6/27 Axios article. And Amazon's delivery speed averages 3.2 days versus six days for all other e-commerce companies.

Earlier this year, FedEx exited its contracts with Amazon and upped its own shipping game. FedEx aims to double its e-commerce package capacity, and to that end it's striking deals with retailers for new package drop-off points and increasing delivery hours. These new investments combined with slowing global trade and global economic growth triggered more than a10% share-price drop in FedEx shares on Wednesday after management warned that it expects EPS to fall 16%-29% this fiscal year.

Uber Technologies also has jumped into the transportation business, with Uber Freight. The company's mobile app lets truckers book multiple loads at one time, allowing them to plan better and keep their trailers full, a 9/17 *WSJ* article reported. Truckers rate pick-up and drop-off facilities on the app, helping other truckers decide which loads they'd like to take on. Sound familiar?

While Amazon and Uber aren't planning to build their own railroads, their entry into the trucking market could pressure the railroad business, given—as we mentioned above—that the two markets compete in certain areas. Maybe railroad CEOs should go talk with their retailer CEO counterparts.

Valuation: Lots of Rotation. The S&P 500's forward P/E is an unsensational 17.1, only 0.3ppt higher than it was one year ago and around where it has stayed for much of the past four to five years. At the sector level, however, valuations have moved sharply this year. Consider the following:

(1) Two interest-rate-sensitive and defensive sectors have seen their forward P/Es increase sharply. The S&P 500 Real Estate sector's P/E, at 43.9, is 5.1 points higher than it was this time last year, and the S&P 500's Utilities sector's forward P/E is almost 3.0 points higher at 19.6—a record high dating back nearly 25 years (*Fig. 13*). Another defensive sector, S&P 500 Consumer Staples, has a forward P/E that's 1.7ppts higher today than at this time last year.

(2) Two Growth sectors have enjoyed multiple expansion too: The S&P 500 Communications Services sector's forward P/E has increased to 17.9, up from 10.5 last year (when it was composed primarily of telecom companies), and the Information Technology sector's P/E at 19.7, is up 1.1 points.

(3) A few sectors have lower P/Es today than a year ago. The S&P 500 Health Care sector's forward P/E has dropped to 14.6, down from 16.2 a year ago, as the presidential election season has taken its toll. The S&P 500's Industrials and Energy sectors' earnings multiples are fractionally (0.4 point) lower than last year. Lastly, the beleaguered S&P 500 Financials sector earnings multiple is 0.2ppt lower today than a year ago.

(4) Here are the 11 S&P 500 sectors' forward P/Es today and one year ago: Real Estate (43.9, 38.8), Consumer Discretionary (21.6, 21.4), Consumer Staples (19.8, 18.1), Information Technology (19.7, 18.6), Utilities (19.6, 16.7), Communications Services (17.9, 10.5), S&P 500 (17.1, 16.8), Materials (17.0, 15.2), Industrials Sector (16.0, 16.4), Energy (15.5, 15.9), Health Care (14.6, 16.2), and Financials (12.1, 12.3) (*Fig. 14*, *Fig. 15*, *Fig. 16*, and *Fig. 17*).

(5) After underperforming Growth stocks for most of the past eight years, Value stocks have outperformed in recent days. The outperformance Growth stocks have enjoyed over the past eight years has been diminishing since mid-2018 (*Fig. 18* and *Fig. 19*).

The S&P 500 Citigroup Growth index trades with a forward P/E of 21.0, near recent peaks and close to where it has been for much of this year. The S&P 500 Citigroup Value index has a much lower forward P/E of 14.1, also near where it has been for much of this year (*Fig. 20*). The gap between the forward P/Es of Growth and Value stocks hasn't been this wide since the go-go days of the tech bubble and its aftermath.

Crypto Update: Blockchain In, Libra Out. Getting Libra approved by financial regulators around the world will be a tough slog. Questions and concerns about Facebook's proposed stablecoin came from finance officials in the US, France, Germany, and European Union (EU) in recent days. Meanwhile, stablecoins being proposed for internal use by some of the country's largest banks seems to be gaining traction. Let's take a look:

(1) *No love from the EU.* European Central Bank board member Benoit Coeure, who also chairs the Bank of International Settlements' committee on payments and market infrastructures, made his doubts about Libra clear. "Stablecoins are largely untested, especially on the scale required to run a global payment system," he said according to a 9/16 Reuters article. "They give rise to a number of serious risks related to public policy priorities. The bar for regulatory approval will be high."

The EU is considering a common set of rules for virtual currencies and has developed its own project for real-time payments in the Eurozone, known as "TIPS." It's also evaluating a central-bank digital currency, which would let consumers use electronic cash that's directly deposited at the ECB. The

system would eliminate the need for bank accounts, financial intermediaries, and clearing counterparties, thereby reducing transaction costs. The project began before Libra's launch, and development could take years.

(2) *France and Germany aren't fans.* Virtual currencies pose risks to consumers, financial stability, and the monetary sovereignty of European states, said the finance ministers of France and Germany in a joint statement, a 9/13 Reuters article reported. So far, Facebook has not convinced them that the Libra project "properly" addresses those concerns.

Instead, France's Finance Minister Bruno Le Maire and Germany's Finance Minister Olaf Scholz threw their support behind public digital currencies issued by central banks. In a joint statement, they said: "We encourage European central banks to accelerate work on issues around possible public digital currency solutions."

(3) *US raises concerns.* Under the existing proposal, Libra would be based and governed in Switzerland. US and Swiss officials met last week to discuss regulatory controls, including the need to ensure that regulations are strong enough to dissuade "bad actors," a 9/10 *WSJ* article reported. Switzerland has already agreed to the stronger cryptocurrency standards adopted this summer by the Financial Action Task Force to combat terror financing and money-laundering.

(4) *Marcus defends Libra.* Libra's co-creator David Marcus defended his cryptocurrency via Twitter, pledging to continue to engage with central banks, regulators, and lawmakers: "Libra is designed to be a better payment network and system running on top of existing currencies, and delivering meaningful value to all consumers all around the world. Libra will be backed 1:1 by a basket of strong currencies. This means that for any unit of Libra to exist, there must be the equivalent value in its reserve. As such there's no new money creation, which will strictly remain the province of sovereign Nations."

(5) *Wells jumps into stablecoins.* Wells Fargo is developing its own version of JPM Coin. Wells Fargo Digital Cash, linked to the US dollar, will be used initially for transactions between the bank's businesses, including cross-border payments. The platform will be able to move money in close to real time, outside of regular operating hours, and will "remove the need for third-party payment intermediaries, and cut time and costs associated with such transactions," a 9/16 CoinDesk article stated. The pilot is expected to kick off next year.

One looming problem: Wells Fargo Digital Cash and JPM Coin operate on different networks that don't communicate. Looks like the race to become the largest network, with the most members, has begun.

CALENDARS

US. Thurs: Jobless Claims 213k, Existing Home Sales 5.37mu, Philadelphia Fed Manufacturing Index 11.0, EIA Natural Gas Storage. **Fri:** Baker-Hughes Rig Count. (DailyFX estimates)

Global. Thurs: UK Retail Sales Total & Ex Fuel 2.9%/2.6% y/y, UK BOE Rate Decision 0.75%, UK BOE Asset Purchase Facility £435b, Japan CPI Core 0.5%y/y, Japan BOJ Rate Decision -0.10%, Australia Employment Change & Unemployment Rate 10k/5.3%, RBA Bulletin, Coeure, Lautenschlager. **Fri:** Eurozone Consumer Confidence -7.0, Canada Retail Sales 0.8%. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) moved back over 3.00 this

week, after six weeks below, as bullish sentiment climbed back above 50.0%. The BBR increased for the third week to 3.16 after falling from 2.74 to 2.35 three weeks ago. Bullish sentiment jumped 9.9ppts—to 53.8% from 43.9%—over the three-week period, as the correction count dropped 8.2ppts—to 29.2% from 37.4%. It was the most bulls since the 57.2% recorded during the final week in July. There have been wide swings between the bullish and correction camps since early June. Meanwhile, bearish sentiment fell for the second week from 18.7% to 17.0%—the lowest percentage since mid-June—after fluctuating in a narrow band from 17.9% to 18.7% the prior seven weeks. The AAII Ratio climbed for the second week to 51.5% last week after falling from 40.1% to 38.2% the previous week, as bullish sentiment rose from 26.1% to 33.1% the past two weeks while bearish sentiment fell from 42.2% to 31.3%.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): Consensus S&P 500 forward revenues and earnings rose w/w to new record highs. Analysts expect forward revenues growth of 5.4% and forward earnings growth of 8.6%, with both measures unchanged w/w. Forward revenues growth is down 0.9ppt 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 8.3ppts 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 5.5% in 2020. They're calling for earnings growth to slow sharply from 24.0% in 2018 to 1.8% in 2019 before improving to 10.3% 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 drop 0.3ppt y/y from 12.0% in 2018 to 11.7% in 2019 before improving to 12.2% in 2020. The S&P 500's forward P/E rose 0.4pt w/w to a seven-week high of 17.1 from 16.7 and compares to an 18-month high of 17.4 in late 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. Similarly, the S&P 500 price-to-sales ratio rose w/w to a seven-week high of 2.07 from 2.02 and compares to an 11-month high of 2.10 in late 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 3/11 S&P 500 sectors, and forward earnings was higher for 5/11 sectors. Health Care, Materials, and Real Estate had 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 have declined from recent multi-year or record highs for four sectors: Communication Services, Real Estate, Tech, and Utilities. However, all sectors remain well above their multi-year lows during December 2018. 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 one sector now: Financials. 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. During the latest week, it rose 0.1ppt for Health Care, dropped 0.1ppt for Financials, and was at a record high for Industrials and Utilities. Here's how the sectors rank based on their current forward profit margin forecasts versus their highs during 2018: Information Technology (21.8%, down from 23.0%), Financials (18.5, down from 19.2), Real Estate (15.9, down from 17.0), Communication Services (15.0, down from 15.4), Utilities (13.0, record high), S&P 500 (12.1, down from 12.4), Health Care (10.6, down from 11.2), Industrials (10.4, record high), Materials (10.2, down from 11.6), Consumer Discretionary (7.5, down from 8.3), Consumer Staples (7.4, down from 7.7), and Energy (6.8, down from 8.0).

US ECONOMIC INDICATORS

Housing Starts & Building Permits (*link*): Lower mortgage rates have finally sent both housing starts and building permits skyward in August, to levels not reached in 12 years. Housing starts rebounded 12.3% last month to 1.364mu (saar)—its highest reading since June 2007, with single-family starts continuing its recent move up. These starts increased for the fifth time in six months, by 4.4% m/m and 16.0% over the period to 919,000 units (saar)—the fourth-best reading since 2007. Volatile multi-family starts rebounded 32.8% to 445,000 units (saar) in August, after a two-month decline of 25.6%. Building permits jumped 7.7% to 1.419mu (saar) last month, building on July's 6.9% spurt—pushing it up to its highest reading since May 2007. Single-family permits advanced for the fourth straight month, by 4.5%m/m and 10.2% over the period to 866,000 units (saar), nearing a new cyclical high. Multi-family permits soared 35.2% during the two months through August, to 553,000 units (saar). The National Association of Home Builders Housing Market Index (HMI) for September shows homebuilders' confidence continued to trend higher since bottoming at the end of last year. The overall index climbed to 68 this month from 56 last December, with the current sales (to 75 from 61 in December) and buyer traffic (50 from 43) components drifting higher and the expected sales (70 from 61) component moving sideways over the past six months—reflecting lack of supply rather than weak demand.

GLOBAL ECONOMIC INDICATORS

Eurozone CPI (*link*): August's CPI rate was below 2.0% for the 10th consecutive month, while the core rate remained just below 1.0%, with both measures matching their flash estimates. The headline rate held at 1.0%—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 2.1% from 1.9% y/y) had the highest rate, followed by services (1.3 from 1.2)—with the former at a six-month high. The rate for non-energy industrial goods (0.3 from 0.4) eased slightly, while the rate for energy (-0.6 from 0.5) fell below zero for the first time since November 2016—slowing steadily from 5.3% in March/April. The core rate—which excludes energy, food, alcohol, and tobacco—remained at 0.9% after accelerating from 0.8% to 1.1% in June. Of the top four Eurozone economies, only France's (1.3% y/y) rate was above August's headline rate of 1.0%, with Germany's (1.0) matching it; rates for Italy (0.5) and Spain (0.4) were below. Meanwhile, Portugal's (-0.1) rate was the weakest among the Eurozone economies, slipping below zero, while the Netherlands and Latvia posted the highest rates, both at 3.1%.

European Car Sales (*link*): EU passenger car registrations (a proxy for sales) took a dive in August, after sales stabilized in July. August sales plunged 8.4% y/y, "mainly the result of the high base of comparison, as August 2018 saw exceptional growth (+31.2%) ahead of the introduction of the new WLTP emissions test on 1 September 2018," according to the report. The top five EU markets were in the red in August, with Spain (-30.8% y/y) and France (-14.1) sales especially hard hit; declines in Italy (-3.1), the UK (-1.6), and Germany (-0.8) were in the low single digits. Passenger cars in July increased 1.4% y/y after contracting 7.8% in June. Over the first eight months of this year, sales fell 3.2% versus the comparable period a year ago, with only Germany (0.9) eking out a gain, while Spain (-9.2) was the weakest among the top five markets; sales in the UK fell 3.4%, with comparable declines in France and Italy, both down 3.0%.

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