



MORNING BRIEFING

October 8, 2019

Cabin Fever

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

(1) Stay Home vs Go Global update. (2) Tactical opportunities abroad. (3) Not venturing too far. (4) US stocks are expensive, but they have better-looking revenues, earnings, and margins. (5) PMIs of emerging economies holding up well, but it would take rebounding commodity prices to warrant overweighting their shares. (6) Lots of woes in Europe, as Trump escalates trade war with the region. (7) Bad sentiment and orders. (8) German auto output may be bottoming. (9) Euro is down, which is good for exporters. (10) ECB ready and willing to fund MMT in Germany.

Strategy: Time to Go Global? Joe and I are getting cabin fever. Cabin fever is a popular term for a relatively common reaction to being isolated in a building for a period of time. In our case, we have been isolated in the US, promoting a Stay Home investment strategy during most of the current bull market. It may be time to venture outside of our home market and Go Global for a while.

A smart fellow at one of our accounts in Austin, Texas told me that he is considering overweighting Europe. Our friends at Capital Group are leaning in the same direction. In a 10/2 [post](#) titled “Life after Brexit: Will the European economy rebound?,” they conclude: “Despite economic headwinds, company-specific investment opportunities remain” in the region. Emerging market economies are also showing some signs of life. Debbie and I see this in their improving PMIs.

Our bottom line is that there may very well be some tactical opportunities to Go Global over the next 6-12 months. If the opportunities do pan out over this period, we will most likely come back home. Furthermore, we may not venture away from home for very long if the opportunities don’t pan out in a short period of time. Consider the following:

(1) *Performance*. Here is the relevant performance derby for the two approaches: The US MSCI stock price index is up 335% since the start of the current bull market on 3/9/09 through Friday’s close. The All-Country World ex-US MSCI is up 104% in dollars and 115% in local currency over this same time. It has been no contest, as the other major stock market indexes have lagged miserably both in dollars and in local currencies: Emerging Markets (105%, 123%), Japan (102, 118), EMU (91, 120), and UK (75, 96) ([Fig. 1](#) and [Fig. 2](#)).

(2) *Valuation*. Stocks in the rest of the world look cheap compared to those in the US. At the end of September, the US MSCI had a forward P/E of 17.3, while the All-Country World ex-US had a 13.3 valuation multiple ([Fig. 3](#)). Keep in mind that the US has tended historically to command a premium P/E compared to the rest of the world, but the recent spread of 4.0 P/E points is among the widest since the start of the data in May 2001 ([Fig. 4](#)).

Here is a collection of the latest forward P/Es for the advanced economies: Italy (11.1), Spain (11.3), UK (12.2), Germany (12.9), Japan (13.4), EMU (13.5), France (14.0), and Canada (14.1) ([Fig. 5](#)).

Emerging markets are also cheap, with a forward P/E of 12.0 at the end of September. Here are the major regional EM valuation multiples: Asia (12.7), Latin America (12.5), Eastern Europe (6.5) ([Fig. 6](#)).

(3) *Forward revenues & earnings*. Also keep in mind that the underlying fundamentals are looking better in the US than elsewhere. The forward revenues per share of the US MSCI stock price index remains on an uptrend in record-high territory and is outpacing the comparable metric for Developed World ex-US. For example, since the start of 2016 through the 9/26 week, the former is up 22.5% while the latter is up 8.1% ([Fig. 7](#)). Over this same period, the forward revenues of the Emerging Markets MSCI is up 11.5%, but has been looking topmy since the summer.

The forward earnings per share of the US MSCI has stalled at a record high this year, while the comparable metrics for Developed World ex-US and Emerging Markets have been trending lower so far this year ([Fig. 8](#)).

(4) *Profit margin*. The forward profit margin of the US MSCI is the highest in the world ([Fig. 9](#)). At the end of September, it was 11.7% in the US, 8.4% in the Developed World ex-US, and 6.6% among Emerging Markets.

Emerging Market Economies: Emerging Again? As we noted yesterday, the PMIs of the emerging economies have been holding up better than those of the advanced economies so far this year. Here are September's M-PMIs for a few of the major emerging economies: Brazil (53.4), China (51.4), India (51.4), Thailand (50.6), and Vietnam (50.5) ([Fig. 10](#)). Some of those in Southeast Asia may be benefitting from manufacturers' moving their supply chains out of China.

Nevertheless, it's hard for us to pound the table on a strategy of overweighting the EM MSCI (in dollars) while the CRB raw industrials spot price index is falling ([Fig. 11](#)). The two series have been very highly correlated since the mid-1990s. That's because the forward earnings of the EM MSCI has also been highly correlated with the CRB index ([Fig. 12](#)).

This suggests that while many emerging economies are benefiting from consumers' rising standards of living, the MSCI index must still be heavily weighted with commodity-producing companies. In other words, the EM MSCI may not be reflecting all the progress and prosperity going on in many of the emerging economies. That dynamic suggests opportunities to invest in undervalued companies that are prospering by catering to consumers but aren't included in the stock index.

Europe I: First, the Bad News. In their 10/2 post cited above, our friends at Capital Group observed: "The United Kingdom is beset with Brexit uncertainty. Germany is teetering on the verge of recession. Protests in the streets of Paris until recently threatened to destabilize the French government. On top of all that, global disruption from the U.S.-China trade war has weighed heavily on Europe's export-dependent economy."

Then last Wednesday, the US escalated its trade war with Europe after the World Trade Organization gave President Donald Trump the go-ahead to impose tariffs on as much as \$7.5 billion worth of European exports annually in retaliation for illegal government aid to Airbus SE.

The 10/2 Bloomberg reported: "The Trump administration is considering a particularly damaging trade weapon known as 'carousel' retaliation, which would enable the U.S. to regularly shift around the targeted goods, people familiar with the deliberations said last month. That would increase trade uncertainty and pain for European businesses."

The latest batch of European economic indicators is also depressing:

(1) *Economic sentiment*. The economic sentiment index for Europe fell to 100.0 during September, the lowest reading since November 2013 ([Fig. 13](#)). It was down to 101.7 in the Eurozone, the lowest since February 2015, signaling that real GDP growth in the region is heading toward zero from only 1.2% y/y during Q2 ([Fig. 14](#)).

Leading the recent decline in Europe has been the sentiment index for the UK. It fell to 88.0 last month to the lowest reading since May 2012 ([Fig. 15](#)). Leading the rout in the industrial components of the sentiment indicator is Germany with a reading of -15.6 during September, the weakest since October 2012 ([Fig. 16](#)).

(2) *Factory orders*. Yesterday, we learned that German manufacturing orders fell during August, as Debbie discusses below. They were down 6.7% y/y. They are down 4.8% y/y in the Eurozone through July ([Fig. 17](#)).

Europe II: Now, the Good News. The good news is that the volume of retail sales remains on an uptrend in the Eurozone, rising 2.1% y/y during August, in record territory ([Fig. 18](#)). The 12-month sum of German auto production may have bottomed during September, a year after tougher auto emission standards were imposed ([Fig. 19](#)). The value of German exports is up 2.0% over the three months through July.

Interestingly, while European equities have lagged those of the US this year, they are up solidly. The region's MSCI is up 7.8% ytd in dollars and 11.7% in local currency through Friday ([Fig. 20](#)). The euro is down 4.7% y/y through Friday's close, which should help exporters in the Eurozone. While the bad news currently outweighs the good news, that's all the more reason to expect a stimulative policy response, especially from German fiscal authorities.

The European Central Bank (ECB) last month cut its key deposit facility rate further into negative territory, from -0.40% to -0.50%, and relaunched a €20 billion per month bond-buying program without setting a termination date. Outgoing ECB President Mario Draghi promoted Modern Monetary Theory in a recent [speech](#).

In effect, he said that the ECB would be delighted to finance €240 billion per year in Eurozone government bonds for the purpose of stimulating economic growth in the region. "When you look at them closely, you realize the task of distributing money to one subject or the other subject, that's typically a fiscal task," he said. "It's a government decision, not the central bank ... It's the political governance of these ideas that needs to be addressed." Incoming ECB chief Christine Lagarde intends to keep pushing fiscal authorities to take advantage of the ECB's largesse.

The Capital Group post concludes: "Although European economic growth has been disappointing so far in 2019, investment returns have charted a decidedly different course—which serves as a timely reminder that the economy and the stock market aren't always on the same page."

CALENDARS

US. Tues: NFIB Small Business Optimism Index 104.1, Headline & Core PPI 1.7%/2.2% y/y, Powell, Kashkari, Evans. **Wed:** Job Openings 7.265m, MBA Mortgage Applications, Wholesale Inventories .04%, DOE Oil Inventories, FOMC Meeting Minutes, Powell. (DailyFX estimates)

Global. Tues: Germany Industrial Production -0.3% m/m/-2.7% y/y, China Caixin NM-PMI 52.9, Carney. **Wed:** Japan Machine Tool Orders, Mexico CPI 3.0% y/y. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings rose for all three of these indexes last week. These indexes began a forward-earnings uptrend during March, but only LargeCap is near a record high. LargeCap's forward earnings has risen during 28 of the past 34 weeks, MidCap's 18 of the past 30 weeks, and SmallCap's 17 of the past 28 weeks. LargeCap's is less than 0.1% below its record high two weeks ago, while MidCap's and SmallCap's are 3.2% and 8.6% below their October 2018 highs. MidCap's forward earnings is near a 14-month low now, while SmallCap's forward earnings is near a 15-month low because analysts are now including a large goodwill writeoff in their 2019 annual forecast for Frontier Communications. 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. During mid-September, 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 was steady at a 34-month low of 1.8% y/y. That's down from 23.2% in September 2018, which was the highest since January 2011. MidCap's -2.4% y/y change is down from -1.0% and is the lowest since January 2010. That compares to 24.1% in September 2018 (the highest since April 2011). SmallCap's -8.4% y/y change was steady w/w, but up from -9.6% the week before that, which was 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%, 1.0%, 11.2%), MidCap (22.7, -4.0, 13.0), and SmallCap (22.4, -16.6, 39.4).

S&P 500/400/600 Valuation ([link](#)): Valuations fell last week for these three S&P market-cap indexes, but remain above their three-month lows from late August. LargeCap's forward P/E dropped 0.1pt w/w to 16.6 and is down 0.6pt 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 was also down 0.1pt w/w, to 15.8 from 15.9. That's 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 fell 0.4pt w/w to a five-week low of 16.6 and is down from a 12-month high of 17.8 in mid-September. That's 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 now matches LargeCap's after being back above for four weeks primarily due to substantially lower forward earnings for Frontier Communications. It had been below for 16 weeks through the end of August—the first time that has happened since 2003.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): With the Q3 books closed, analysts trimmed their forecasts for the quarter at a slightly slower rate last week than during the previous week. The S&P 500's Q3-2019 EPS forecast dropped 7 cents w/w to \$41.22. That represents an earnings decline of 3.4% y/y compared to the prior week's forecasted earnings drop of 3.2%. The consensus' \$41.22 estimate is down 4.1% in the 14 weeks since the start of the quarter, which compares to a 2.4% drop for Q3 over the similar 14 weeks. While the consensus Q3 EPS estimate is below our forecast of \$43.00 and is now below the \$41.22 reported for Q2, we are expecting slightly positive y/y earnings growth of 0.8%. On a pro forma basis, Q3 earnings are expected to decline 2.7% y/y, which would be the first drop in 13 quarters and compares to y/y gains of 3.2% in Q2, 1.6% in Q1, 16.9% in Q4-2018,

and 28.4% in Q3-2018 (which marked the peak of the current earnings cycle). Seven of the 11 sectors are expected to record positive y/y earnings growth in Q3-2019, with none rising at a double-digit percentage rate. That compares to seven positive during Q2, when three rose at a double-digit percentage rate. However, eight sectors are expected to beat the S&P 500's Q3 growth rate, up sharply from just three beating the S&P 500 during Q2. Industrials, Materials, and Utilities are the only sectors expected to post better (or less worse) growth on a q/q basis during Q3. On an ex-Energy basis, the consensus expects earnings to fall 0.8% y/y in Q3. That compares to ex-Energy gains of 3.9% in Q2 and 3.0% in Q1, and is well below the 14.2% y/y gain in Q4-2018. Here are the latest Q3-2019 earnings growth rates versus their Q2-2019 growth rates: Real Estate (2.9% in Q3-2019 versus 3.1% in Q2-2019), Health Care (2.5, 10.3), Utilities (2.2, 1.1), Financials (1.6, 10.0), Industrials (1.2, -9.5), Consumer Discretionary (1.2, 2.7), Consumer Staples (0.1, 1.7), Communication Services (-0.8, 17.6), Information Technology (-7.5, -2.2), Materials (-10.4, -12.7), and Energy (-31.0, -8.9).

S&P 500 Q3 Earnings Season Monitor ([link](#)): With just over 4% of S&P 500 companies finished reporting revenues and earnings for Q3-2019, revenues and earnings are beating the consensus forecasts by 0.9% and 5.3%, respectively. Those are about the same rates as during the same point in Q2, but the percentages of companies showing a positive revenue surprise and positive y/y revenue growth are weaker. Of the 22 companies in the S&P 500 that have reported through mid-day Tuesday, 86% exceeded industry analysts' earnings estimates. Collectively, the reporters have a y/y earnings decline of 12.1%, primarily due to Micron Technology's earnings deceleration. On the revenue side, 55% of companies beat their Q1 sales estimates so far, with results 3.4% higher than a year earlier. Ex-Micron, y/y earnings growth for the S&P 500 jumps to 9.3% from -12.1% and revenue growth improves to 6.0% from 3.4%. Overall Q3 earnings growth results are positive y/y for 77% of companies, and revenues have risen y/y for 82%. These figures will change markedly as more Q3-2019 results are reported in the coming weeks, but what companies say about their expectations for Q4-2019 and their early peek at 2020 prospects will be investors' main focus.

GLOBAL ECONOMIC INDICATORS

Germany Manufacturing Orders ([link](#)): Factory orders fell for the fifth time this year, dropping 0.6% in August and 7.0% ytd, to its lowest reading since September 2016. Domestic orders tumbled 2.6% in August, while foreign orders rose 0.9%, with billings from both inside (1.5%) and outside (0.4) the Eurozone advancing during the month. On a year-to-date basis, both domestic (-9.5% ytd) and foreign (-5.1) orders are down sharply, with the latter showing orders contracting both inside (-3.2) and outside (-6.3) the Eurozone. The main industrial groupings show a sea of red so far this year, except for strong growth in foreign orders of consumer durable goods. Overall consumer durable goods orders are up 4.7% ytd, boosted by an 18.2% jump in foreign orders, while domestic orders are down 13.1%. Within foreign orders, consumer durable goods billings from both inside (19.1% ytd) and outside (17.7) the Eurozone are posting double-digit gains through the first eight months of this year. Meanwhile, capital goods is the weakest among the main industrial groups, with total orders falling 8.8% ytd, as both domestic (-11.1% ytd) and foreign (-7.6) billings dropped significantly—the latter on widespread declines. Intermediate goods billings have contracted 4.6% ytd, driven by a 7.3% drop in domestic orders; the decline in foreign orders (-1.6) was modest—with billings from outside the Eurozone recording a small gain. Orders for consumer nondurable goods sank 5.7% ytd, led by a 9.5% drop in domestic orders; foreign orders (-3.0% ytd) fell at one-third the pace of domestic ones.

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