



MORNING BRIEFING

October 23, 2018

Some Well-Performing Cyclical

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

(1) Outstanding year for S&P 500 so far. (2) Defensive sectors have outperformed over past three months. (3) But some cyclical sectors have performed well too. (4) Lower mortgage rates boost housing-related industries. (5) Semis on a roller-coaster. (6) A bottom in worldwide semi sales? (7) Trucking along. (8) Doing well despite trade, Boeing, and GM woes. (9) Gene editing for fun and profit. (10) Prime editing DNA.

Strategy: The Outstanding Standouts. Despite all the handwringing and unsettling political headlines, this has been a relatively spectacular year for the S&P 500. It's up 19.5% ytd through Tuesday's close ([Fig. 1](#)). Of course, some of that above-par performance is thanks to the market's December selloff, which meant the S&P 500 began 2019 at a depressed level. But even if the clock starts on December 29, 2017, the S&P 500 rose a moderate 12.1%, and since December 30, 2016 it has returned 33.8%.

The last three months haven't been quite so spectacular. As we've discussed previously, since peaking this summer, the S&P 500 has dipped 1.0% and defensive sectors enjoyed the top returns. Here's the S&P 500 sectors' performance derby from 7/26 through Tuesday's close: Real Estate (8.0%), Utilities (7.3), Consumer Staples (0.8), Health Care (-0.2), Industrials (-0.5), Financials (-0.9), S&P 500 (-1.0), Communication Services (-2.0), Consumer Discretionary (-2.2), Information Technology (-2.3), Materials (-3.3), and Energy (-5.9).

While defensive sectors have led the way since July, a number of very economically sensitive industries have turned in remarkably strong performances over the same time period. Here they are: S&P 500 Homebuilding industry is (up 24.0%), General Merchandise Stores (22.3), Trucking (14.0), Construction Materials (12.2), Electronic Equipment & Instruments (10.2), Home Improvement Retail (9.2), Construction & Engineering (9.1), Industrial REITS (8.9), and Semiconductor Equipment (8.4).

Let's look at what's driving some of these economically sensitive industries.

(1) *Lower rates lend a hand.* The drop in interest rates has helped some of the best performing industries. The 10-year Treasury yield has fallen from 3.24% on 11/8/18 to 1.78% ([Fig. 2](#)). The drop in mortgage rates makes residential and commercial real estate more affordable for those who need financing. The interest rate on fixed-rate home mortgages has fallen to 4.00% from a peak of 5.00% in November 2018 ([Fig. 3](#)). Lower rates helped new home sales rebound from a slump earlier this year ([Fig. 4](#)).

The S&P 500 Homebuilding industry is the second-best performing industry since July 26, and

it has been in rally mode since 12/24/2018 rising 61.1% ([Fig. 5](#)). The industry is expected to post earnings growth of 6.1% this year and 8.0% in 2020 ([Fig. 6](#)).

Meanwhile, the Federal Reserve has lowered the federal funds rate two times this year—in July and September. The yield curve, as measured by the 10-year Treasury and the 3-month Treasury bill, hit its most negative level on 8/28 (at 48bps) and has since turned slightly positivity ([Fig. 7](#)). A positively sloped yield curve was good news for the S&P 500 Diversified Banks industry, which has climbed 3.2% since July 26, but not as helpful to Regional Banks (-0.3). ([Fig. 8](#)).

(2) *Semis take two steps forward, one step back.* There are other economically sensitive industries, like S&P 500 Trucking and S&P 500 Semiconductor Equipment, that are less directly impacted by interest rates, but have also had a great few weeks. The Semiconductor Equipment industry has gained 8.4% since July 26, while Semiconductors industry has outperformed the S&P 500, but not by much (-0.4%). (both are through Tuesday's close.) On a ytd basis, Semiconductor Equipment and Semiconductors have both led the market. Semi Equipment is the top performing industry ytd (68.0%) and Semiconductors (26.0%) has beaten the market by a nice margin.

Worldwide semiconductor sales had been falling from their October 2018 peak through June, when they appear to have bottomed because sales have climbed in July and August ([Fig. 9](#)). Despite the uptick in sales, concerns have lingered about the impact of the US-China trade war, which played a starring role in Texas Instruments' earnings report Tuesday after the close. The company's Q4 earnings forecast missed analysts' estimates by a mile. The company projects a range of 91 cents to \$1.09 a share for earnings, far below analysts' forecast of \$1.28 a share.

Texas Instruments blamed the US-China trade war for causing customers to pull back. "It is due to macro events, and specifically, the trade tensions. [I]f you think about when there's tensions in trade and obstacles to trade, what do businesses do? They become more cautious and they pull back. And we are at the very end of a long supply chain," TI CFO Rafael Lizardi told analysts, according to 10/22 MarketWatch [article](#). Shares of TI fell 10% in aftermarket trading Tuesday and dragged down other semiconductor stocks as well.

(3) *Trucking on.* With earnings declining this year, it's somewhat surprising that the stock of the S&P 500 Trucking industry's one constituent, J.B. Hunt Transport Services, has risen 14.0% since July 26 and 38.3% since bottoming on 5/29 ([Fig. 10](#)). Earnings are expected to decline 4.7% this year, but investors may be focused instead on 2020, when earnings are forecast to climb 9.8% ([Fig. 11](#)).

The ATA Truck Tonnage index has been volatile but remains in record high territory. At 117.6 in September, the index is down 3.8% from its July peak, but still up 3.5% y/y ([Fig. 12](#)). On the other hand, after rising sharply in 2018, prices for truck freight transportation fell 0.2% in the September PPI ([Fig. 13](#)). Of course, that's good news for the customers of the trucking industry.

(4) *Industrials moving forward despite headwinds.* In addition to Trucking, there are a number of other industries in the Industrials sector that have outperformed the S&P 500 since July 26. Their outperformance is notable given the trade dispute, the slow European economy, Boeing's problems with the 737 Max, and the strike at General Motors. The standouts since July 26 are Trading Companies & Distributors (10.9%), Construction & Engineering (9.1), Building Products (4.9), Electrical Components & Equipment (3.5), Agricultural & Farm Machinery (2.8), Construction Machinery & Heavy Trucks (1.3), Railroads (0.8), Aerospace & Defense (0.6), and Industrial Machinery (0.1).

Yesterday Boeing reported huge earnings miss, but the company's shares rallied anyway because it continued to forecast the Max 737 would return to the skies in the fourth quarter and maintained a production rate of 42 planes per month. The company posted earnings of \$1.45 a share, compared to \$2.09 a share that analysts expected.

Honeywell International CEO Darius Adamzyk sounded extremely optimistic in a CNBC [article](#) yesterday, which follows modestly disappointing earnings report last week. Honeywell reported Q3 adjusted earnings per share of \$2.08, seven cents higher than analysts' forecast, but it also gave Q4 earnings per share guidance of \$2.00-\$2.05, below analysts' target of \$2.06. Companies that manufacture airline replacement parts, like Honeywell, have benefitted from the Boeing 737 Max grounding because it has meant the airlines fly older planes, which require more maintenance and repairs.

Despite the light Q4 forecast, Adamzyk remained confident. "Overall we're actually not seeing the softening of this environment, and actually I was very pleased with the bookings, which is really a predictor of our future," he said Wednesday on CNBC. "Our backlog was up high single digits for the quarter, and we had double-digit booking gains in places like China and the Middle East, Latin America and so on. A lot of markets that really aren't doing well. Even Europe was up nearly double-digits for us as well," he said. The company's shares are up 27.9% ytd.

Disruptive Technologies: Gene Fixing. The world of gene editing is growing more sophisticated by the day. Scientists are developing new, more accurate techniques and applying existing methods to new diseases. It all leads to very exciting medical trials that give hope to millions of patients. I asked Jackie to review the latest developments.

(1) *Tackling blood diseases.* Sickle cell disease is caused by a genetic defect that turns red blood cells into hard, sticky, misshapen cells. These cells don't carry oxygen well and clot the bloodstream, damaging organs, causing pain, and potentially resulting in stroke or heart attack. ARK Investment's [newsletter](#) highlights a study underway that hopes to cure this disease using gene editing. Doctors are taking out patients' bone marrow cells, editing the cell's genes with CRISPR, and putting them back into the patients' bodies.

"Scientists used CRISPR to modify a gene in the cells to make them produce fetal hemoglobin, a protein that babies usually stop making shortly after birth. The hope is that the protein produced through the gene-editing treatment will give sickle cell patients like Gray healthy red blood cells," a 10/10 NPR [article](#) reported.

Crisper Therapeutics and Vertex Pharmaceuticals, which are sponsoring the sickle cell study, also used CRISPR earlier this year to treat a German patient with beta thalassemia, a similar blood disorder. In July they reported that the patient's edited cells started functioning in the bone marrow.

(2) *Other CRISPR trials underway.* Scientists at the University of Pennsylvania are running trials to see if CRISPR can cure relapsed cancers, like multiple myeloma or melanoma. The scientists modify patients' T cells, an immune cell that circulates in the blood, to make them more efficient at fighting cancer, a 9/3 Smithsonian.com [article](#) reported.

Crisper and Vertex are conducting another trial using CRISPR to treat non-responsive or relapsed non-Hodgkin's lymphoma. And lastly Editas Medicine and Allergan began a trial using CRISPR to treat inherited childhood blindness. It will be the first CRISPR trial where the cells are edited while still in the patients' bodies.

(3) *New and improved gene editing.* Harvard University and MIT researchers think they have improved upon CRISPR gene editing, by making the process more accurate. Prime editing, they claim, edits DNA with "incredible" precision and introduces fewer errors than previous gene-editing techniques.

CRISPR makes cuts across both strands of double-stranded DNA and either deletes genes or pastes new genes in the gap. CRISPR can make errors when the cuts are made at the wrong place or errors are introduced into the genes. Prime editing cuts just one strand of the DNA and inserts base letters into the strand. The Prime editor then nicks the other DNA strand and the cell copies what's in the first edited strand.

The researchers edited human cells to fix sickle cell and Tay-Sachs disease and they believe Prime editing can be used to treat about 89% of the 75,112 human genetic mutations that cause disease, a 10/21 CNET [article](#) reported.

Both techniques have pros and cons. Prime editing works best when only a single base needs to be changed on a DNA, as with Tay-Sachs disease. But when larger sections of DNA need to be altered, as would be necessary to affect the genes involved with hereditary heart disease, CRISPR would be the better vehicle, a 10/21 Smithsonian.com [article](#) explained. Also, the Prime editor is larger than CASPR, so scientists have to figure out how it could be put into living cells in living organisms.

CALENDARS

US. Thurs: Durable Goods Orders Total & Ex Transportation -0.7%/-0.2%, Core Capital Goods Orders & Shipments 0.0%/-0.2%, Jobless Claims 215k, New Home Sales 703k, IHS Markit M-PMI & NM-PMI 50.7/51.0, Kansas City Fed Manufacturing Index -4, EIA Natural Gas Storage. **Fri:** Consumer Sentiment Index 96.0, Baker-Hughes Rig Count. (DailyFX estimates)

Global. Thurs: Eurozone, Germany, and France C-PMI Flash Estimates 50.4/48.9/50.9, Eurozone, Germany, and France M-PMI Flash Estimates 46.0/42.0/50.0, Eurozone, Germany,

and France NM-PMI Flash Estimates 51.9/52.0/51.5, ECB Rate Decision 0.00%, ECB Deposit & Marginal Lending Facility Rates -0.50%/0.25%, Draghi. **Fri:** Germany Ifo Business Climate, Current Assessment, and Expectations Indexes 94.5/98.0/91.0, Germany Gfk Consumer Confidence 9.8, Japan Machine Tool Orders, ECB Survey of Professional Forecasters, Villeroy. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) is approaching 3.00 again, rising for the second week this week to 2.95; it fell from 3.28 to 2.77 the previous two weeks. The wide swings between the bullish and correction camps since early June continue. Bullish sentiment is up 5.2ppts the past two weeks to 52.8%, after plunging 7.7ppts the prior week from 55.3% to 47.6%. Meanwhile, the correction count is down 5.9ppts the past two weeks to 29.3%, after jumping 7.6ppts the prior week from 27.6% to 35.2%. Bearish sentiment edged up to 17.9% this week after edging down from 17.2% to 17.0% last week—fluctuating in a narrow band most of this year. The AAI Ratio climbed to 52.0% last week after falling from 46.9% to 31.6% the previous two weeks. Bullish sentiment rose from 20.3% to 33.6% last week, while bearish sentiment fell from 44.0% to 31.3%.

S&P 500 Q3 Earnings Season Monitor (*link*): With nearly 25% of the S&P 500 companies finished reporting revenues and earnings for Q3-2019, revenues and earnings are beating the consensus forecasts by 0.9% and 3.9%, respectively. At the same point during the previous earnings season for Q2, revenues and earnings had beaten forecasts by a smaller 0.5% and 2.9%, respectively. A higher percentage of companies are recording a positive earnings surprise—82% in Q3 versus 77% in Q2. However, a slightly lower percentage of companies are showing a positive revenue surprise—63% versus 64%. Of the 124 companies in the S&P 500 that have reported through mid-day Wednesday, they have recorded a y/y earnings gain of 0.8%, dragged down by Micron Technology's earnings deceleration. On the revenue side, results are 4.3% higher than a year earlier. Ex-Micron, y/y earnings growth for the S&P 500 jumps 2.9ppts to 3.7% and revenue growth improves 0.5ppt to 4.8%. Overall, Q3 earnings growth results are positive y/y for 72% of companies versus a lower 70% at the same point in Q2, and revenues have risen y/y for 78% compared to a much lower 73% in Q2. These figures will continue to change markedly as more Q3-2019 results are reported in the coming weeks, but the early results indicate that y/y earnings growth could be positive after all. However, what companies say about their expectations for Q4-2019 and their early peek at 2020 prospects will be investors' main focus.

MSCI World & Region Net Earnings Revisions (*link*): Analysts' recent earnings revisions through October suggests more pessimism about US profits, but less worries about the rest of the World outside of EM Latin America. The AC World ex-US MSCI's NERI was negative for a 19th month, but improved to -7.1% from -7.7% in September. That's up from a 33-month low of -8.4% in January. The US's NERI was negative for the 11th time in 12 months, slipping to an eight-month low of -6.7% from -6.2%—well below its corporate-tax-rate-cut-boosted record high of 21.8% in March 2018. Here are October's scores among the regional MSCIs: EM Eastern Europe (-3.4% in October, up from -3.5% in September), EM Asia (-5.8 [12-month high], -7.0), Emerging Markets (-5.9 [12-month high], -7.0 [20-month low]), EMU (-6.2, -7.9), EM Latin America (-6.2, -5.6), Europe ex-UK (-6.4, -7.8), United States (-6.7 [eight-month low],

-6.2), Europe (-6.8, -7.1), AC World (-7.0, -7.3), AC World ex-US (-7.1, -7.7), and EAFE (-8.1, -8.4).

MSCI Countries Net Earnings Revisions ([link](#)): NERI was positive for 2/44 MSCI countries in October, unchanged from September and matching the lowest count since March 2016. That compares to 11/44 countries positive in May, which was the highest reading since October. NERI improved m/m in October for 25/44 countries, up from 17/44 in September and compares to compares to 28/44 improving in May. Among the countries with improving NERI in October, Taiwan was at a 14-month high, followed by 12-month highs for Germany, Korea, and Portugal. Among countries with weaker NERI m/m, Hong Kong was the lowest since April 2009, followed by Indonesia (47-month low), Canada (42), the Czech Republic (37), and Canada (11). The three-month positive NERI streaks for Hungary and Israel are the best among countries. South Africa's NERI has been negative for 65 straight months, followed by the negative streaks of Mexico (36 months), Denmark (27), and Germany (27). The highest NERI readings in October: Israel (5.9%), Hungary (5.6), Taiwan (-0.4), the Philippines (-0.8), Sweden (-1.4), Brazil (-2.4), and Portugal (-2.6). The weakest NERIs occurred this month in Peru (-18.1), Hong Kong (-14.2, 126-month low), Finland (-14.0), Australia (-13.8), and Chile (-12.1).

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