



MORNING BRIEFING

December 10, 2019

What's in Style?

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

(1) Is it SMidCap's turn to outperform? (2) Fed's third rate cut this year along with yield curve reversal have consequences. (3) Smaller firms' profit margins may be getting squeezed more than larger ones by tight labor market. (4) Margins higher for large companies than small ones. (5) Growth vs Value: Another perspective. (6) Go Global isn't rising to the occasion so far. (7) Germany hasn't bottomed yet. (8) OECD leading indicators bottoming, but not recovering. (9) China's exports and imports stalled at record highs. (10) Forward revenues still moving forward in many places.

Strategy I: Small, Medium, and Large. The S&P 500 LargeCap stock price index has outperformed the S&P 400 MidCaps and S&P 600 SmallCaps since 12/24/18 ([Fig. 1](#)). The former peaked last year at 2930.75 on 9/20 ([Fig. 2](#)). On Friday, it was up 7.3% from that peak and close to its 11/27 record high. Both the S&P 400/600 (i.e., the "SMidCaps") are still below their 2018 highs.

The SMidCaps may be starting to outperform the LargeCaps. The Fed's third rate cut this year seems to have reduced fears of a US and global recession, as evidenced by the yield-curve spread, which bottomed on 8/30 at -62bps and was back up above zero at 23bps on Friday ([Fig. 3](#)). Generally speaking, smaller companies are viewed as riskier during recessions than are large companies.

The problem is that it is getting harder to find workers, which may be harder for small companies to do than for large ones. That makes it tougher for the smaller ones to grow since they tend to do so by expanding their payrolls more so than larger companies. The larger ones may be better at using technology to boost the productivity of their workers. This would explain why the aggregate profit margin of the LargeCaps is higher than the profit margin of the SMidCaps, and also why the former has held near its record high this year while the SMidCap margin has been squeezed significantly ([Fig. 4](#)).

Last Wednesday, I visited one of our NYC accounts, who manages a portfolio of SmallCaps. She invests in the growthier names in her universe and is especially keen on companies that either provide productivity-enhancing technological tools or use them to boost productivity. Among her recent homeruns are SmallCap software companies.

Let's have a closer look at the relevant data:

(1) *S/M/L employers.* The unemployment rate has been below 4.0% for the past 10 consecutive months and for 16 of the past 17 months ([Fig. 5](#)). It is highly inversely correlated with the percentage of small business owners who say that they have job openings. This year, more than a third of them have been saying so, which has been a record high since the start of the data in 1974.

ADP payroll data show that small companies with 1-49 workers employ more workers (52.8 million during November), than either medium-sized companies with 50-499 workers (47.0 million) or large companies with over 500 workers (29.7 million) ([Fig. 6](#)). Since January 2011, the S/M/Ls have

increased their payrolls by 7.4 million, 8.1 million, and 5.4 million.

(2) *S/M/L profit margins*. Joe and I derive weekly profit margin series for the S&P 500/400/600 by dividing the forward earnings of each by their respective forward revenues ([Fig. 7](#) and [Fig. 8](#)). All three weekly series track their respective actual quarterly profit margins very closely ([Fig. 9](#)).

The weekly forward profit margin of the S&P 500 has been holding up near last year's record high of 12.4% during the 9/13/18 week. It was 12.0% during the last week of November, well above the 11.1% reading at the end of 2017, just before Trump's corporate tax cut pushed it higher. On the other hand, the forward profit margin for MidCaps has given up about half of the boost from the tax cut. It was down to 7.0% during the 11/28 week, the lowest since the 6.9% before the tax cut. The forward profit margin for SmallCaps peaked at 5.8% in October of last year, falling to 4.9% at the end of November and now matches the reading just before the tax cut.

(3) *S/M/L sectors*. Joe and I monitor the forward profit margins of the S&P 500/400/600 sectors ([Fig. 10](#)). The data are available weekly since 2006. The LargeCap's margin has almost always exceeded those of the SMidCaps. Interestingly, this year in the Financials sector, the SmallCaps have exceeded the margins of the LargeCap and MidCap Financials.

We also notice that the profit margin of the S&P 500 Industrials sector is on an uptrend in record territory. The same can be said of the Utilities sector's margin. Not surprising is that margins have been getting squeezed especially hard this year in Energy and Materials.

Strategy II: Growth vs Value Market-Cap Shares. Joe and I aren't big fans of the Growth-vs-Value style distinction. We prefer focusing on sectors and industries. The Fed's third rate cut this year and the reversal in the yield curve noted above seem to explain why S&P 500 Value has outperformed S&P 500 Growth since 8/27 ([Fig. 11](#)). However, it makes more sense to us that both of these developments explain why the S&P 500 Banks industry has outperformed recently, given that many of the companies within it tend to be classified as "Value."

By the way, the average of the M-PMI and NM-PMI has been a good leading indicator for the spread between the yearly percent changes in S&P 500 Growth versus Value during the current bull market ([Fig. 12](#)). The weakness in this average PMI since early last year set the stage for the recent outperformance of Value relative to Growth.

I asked Joe to determine the market-cap shares of Growth versus Value for the S&P 500/400/600 sectors. Here are his major findings as of Friday's close (also see [Table](#)):

(1) *Financials*. The Financials sector has the highest market-cap shares in the S&P 500/400/600 Value indexes at 18.6%, 20.9, and 19.2. These compare to the following shares in the S&P 500 Growth index: 6.9, 11.8, and 13.7.

(2) *Information Technology*. The Information Technology sector is the biggest market-cap sector in the S&P 500 Growth index (at 22.7) and in the S&P 400 Growth index (at 17.0).

It is in fourth place in the S&P 600 Growth behind Health Care (18.9), Industrials (17.3), and Financials (13.7).

(3) *Communication Services*. The Communication Services sector is the second largest one in the S&P 500 at 17.9. It's relatively small in the Value index at 6.5, and even smaller in both S&P 400/600 Growth and Value.

(4) *Industrials*. The Industrials sector tends to have a higher market-cap share in the Value indexes than in the Growth indexes of the S&P 500/400/600: S&P 500 (8.8 Growth, 10.3 Value), S&P 400 (14.9, 19.4), and S&P 600 (17.3, 17.5).

Strategy III: Stay Home vs Go Global. In early October, Joe and I figured that with a third rate cut for this year likely by the end of the month and the reversal of the yield curve, it might be time to look for some Go Global opportunities as an alternative to our long-held Stay Home recommendation. In particular, emerging economy stocks, bonds, and currencies tend to do better when the Fed is easing than when it is tightening credit conditions in the US. European companies that do significant business in emerging economies also would benefit in this scenario. However, Friday's big jobs report favored Stay Home, which continues to outperform.

What is Go Global waiting for? Perhaps a significant de-escalation of Trump's various trade wars. That could happen soon with China. However, just last week, Trump slapped tariffs on steel imports from Argentina and Brazil, and may soon do so on French wine.

More signs of life from the global economy would also benefit Go Global. The problem is that the slide in the CRB raw industrials spot price index, which started last summer, continued through the end of last week ([Fig. 13](#)). The good news is that the Emerging Markets MSCI stock price index (in dollars), which in the past has been highly correlated with the commodity index, has been holding up very well so far this year. But it isn't outperforming the US MSCI.

Let's review the latest batch of global economic indicators:

(1) *German orders and output*. The news out of Europe, particularly Germany, remains depressing. Yesterday, Debbie discussed German factory orders and production. The former edged down 0.4% during October, following a gain of 1.5% the month before, but it is down 5.5% y/y ([Fig. 14](#)). The weakness has been in both domestic orders (down 7.5% y/y) and foreign ones (down 4.1% y/y) ([Fig. 15](#)).

Really ugly is the 1.5% m/m and 6.3% y/y freefalls in production (excluding construction) during October. The small uptick in the 12-month sum of German passenger car production during October has been followed by a new low during November, down 9.3% y/y ([Fig. 16](#)).

(2) *Leading indicators*. The composite leading indicator for the OECD countries has stopped falling, holding steady at 99.1 in October, the same reading as for August and September. The OECD-Europe index posted 99.2 for the seventh month in a row, with indexes in the UK, Italy, and Spain falling over the period, while France's has held steady in recent months and Germany's ticked up in October for the first time in two years.

The US index also showed improvement in October, edging up to 98.9 from 98.8 the month before. The rest of the world trended downward or held steady. Japan's index fell for the 12th consecutive month to 99.2, the lowest since December 2009.

Among the four BRICs, three are below 100.0: China (99.2), India (99.3), and Russia (99.5). Brazil (102.2), on the other hand, has been strong for a while, registering readings above 100.0 since June 2017. (See our [Global Leading Indicators](#).)

(3) *China trade*. Debbie and I track Chinese merchandise exports and imports on a seasonally adjusted basis. Both edged down during November. Both have stalled at record highs over the past year, with

exports up only 1.1% y/y and imports up 2.4%.

We also track the 12-month sum of Chinese exports by destination. The data through October show the following y/y growth rates: Emerging economies (5.4% to a record high), advanced economies (1.2), Eurozone (7.9 to a record high), South Korea (7.8 to a record high), Australia (3.9 to a record high), Japan (1.7), and US (-8.1). (See our [China Trade](#).)

(4) *Forward revenues*. We also track forward revenues for the major MSCI indexes around the world in our [MSCI Metrics Comparisons](#). They are showing that the forward revenues of the All Country World MSCI remains on a very gradual upward trend since early 2018, weighed down by the EMU, UK, and Japan. On the other hand, the US remains on a solid uptrend, and Emerging Markets may have bottomed during the summer.

Here are y/y growth rates in forward revenues through the 11/28 week for selected MSCIs: All Country World (4.3%), Emerging Markets (7.0), EMU (3.4), UK (1.2), Japan (1.4), US (4.9), China (8.7), India (7.3), and Brazil (4.4).

CALENDARS

US. Tues: NFIB Small Business Optimism Index 103.0, Productivity & Unit Labor Costs -0.1%/3.4%. **Wed:** Headline & Core CPI 2.0%/2.3% y/y, Monthly Budget Statement -\$206.9b, MBA Mortgage Applications, DOE Crude Oil Inventories, FOMC Rate Decision 1.63% (1.50%-1.75%), Interest Rate on Excess Reserves 1.55%, Powell. (DailyFX estimates)

Global. Tues: Eurozone ZEW Economic Sentiment Survey, UK GDP 0.1% m/m/0.0% 3m/3m, UK Headline & Manufacturing Industrial Production -1.2%/-1.4% y/y, UK Trade Balance - £2.7b, China Direct Investment, Georgieva. **Wed:** UK General Election, Japan Machine Orders -1.7% y/y. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): The forward earnings of MidCap and SmallCap rose for a third week in a row, and LargeCap's was up for a second after dropping a week earlier. These indexes began a forward-earnings uptrend during March, but stumbled from July to November. LargeCap's forward earnings has risen during 30 of the past 43 weeks, MidCap's 22 of the past 39 weeks, and SmallCap's 20 of the past 37 weeks. LargeCap's is just 0.3% below its record high 12 weeks ago, while MidCap's and SmallCap's are 5.3% and 9.0% below their October 2018 highs. MidCap's forward earnings is near an 18-month low now, while SmallCap's forward earnings is near September's 17-month low because analysts are now including a large goodwill writeoff in their 2019 annual forecast for Frontier Communications. At their bottoms in early 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 dropped to 1.0% y/y from 1.1%. That matches mid-November's 38-month low of 1.0% and is down from 23.2% in September 2018, which was the highest since January 2011. MidCap's was down w/w to -5.3% y/y from -5.1%, and compares to -5.5% in mid-November, which was the lowest since December 2009. That also compares to 24.1% in September 2018 (the highest since April 2011). SmallCap's -7.0% y/y change is up from -9.6% in mid-September, which was the lowest since December 2009 and compares to an eight-year high of 35.3% in October 2018. 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%, 0.1%, 9.8%), MidCap (22.7, -7.3, 12.2), and SmallCap (22.4, -19.7, 36.6).

S&P 500/400/600 Valuation ([link](#)): Valuations rose for the eighth time in nine weeks for these three S&P market-cap indexes to their highest levels in over a year. LargeCap's forward P/E rose 0.1pt w/w to a 22-month high of 17.8 from 17.7. That compares to a five-year low of 13.9 during December 2018 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 edged up less than 0.1pt w/w, to a 21-month high of 17.1. That's up from 13.0 during December 2018, 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 also rose less than 0.1pt, to a 14-month high of 17.9. That's well above its seven-year low of 13.6 during December 2018 and compares to its 15-year high of 20.5 in December 2016, when Energy's earnings were depressed. SmallCap's P/E was above LargeCap's for the seventh time in eight weeks. It had been below for four months through the end of August—the first time that has happened since 2003.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): With less than a handful of companies left to report Q3 earnings, revisions are slowing. The Q4 EPS forecast dropped just 3 cents w/w to \$40.78. That represents a decline of 1.0% on a frozen actual basis and a drop of 0.2% y/y on a proforma basis. That compares to a 0.4% decline in Q3 and 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). If the y/y earnings decline comes to pass in Q4-2019, it would be the second straight decline and the first drop since earnings fell y/y for four straight quarters through Q2-2016. However, seven of the 11 sectors are expected to record positive y/y earnings growth in Q4, with two rising at a double-digit percentage rate. That compares to seven positive during Q3, when none rose at a double-digit percentage rate. The same seven sectors are expected to beat the S&P 500's 1.0% decline in Q4 as in Q3; that's up sharply from just three beating the S&P 500 during Q2. Six sectors are expected to post improved growth on a q/q basis during Q4: Communication Services, Energy, Financials, Materials, Tech, and Utilities. On an ex-Energy basis, the consensus expects earnings to rise 2.1% y/y in Q4. That compares to ex-Energy gains of 2.2% in Q3, 3.9% in Q2, and 3.0% in Q1. However, that's well below the 25.0% and 14.2% y/y gains in Q3- and Q4-2018, respectively. Here are the latest Q4-2019 earnings growth rates versus their nearly final Q3-2019 growth rates: Utilities (14.5% in Q4-2019 versus 6.7% in Q3-2019), Financials (12.4, 2.4), Health Care (6.1, 8.8), Real Estate (3.7, 5.6), Communication Services (1.8, -1.5), Consumer Staples (0.6, 3.6), Information Technology (0.3, -1.7), Industrials (-5.0, 3.6), Materials (-8.4, -11.0), Consumer Discretionary (-12.0, 1.7), and Energy (-34.2, -37.8).

GLOBAL ECONOMIC INDICATORS

Global Leading Indicators ([link](#)): In October, the OECD's composite leading indicators (CLIs)—designed to anticipate turning points in economic activity relative to trend six to nine months ahead—now point to stable growth momentum in the OECD area as a whole, “but with growth remaining below trend in all major OECD economies and most large emerging economies.” October's OECD CLI held at a decade low of 99.1. Among the major OECD economies, stable growth momentum is still the assessment for both France (99.5) and Canada (99.0)—and now is also the assessment for Italy (99.1) and Japan (99.2), an upgrade from last month's assessment. The report notes that signs of stabilizing growth momentum are now also emerging in the US (98.9) and Germany (98.8), along with the UK (98.9)—where large margins of error remain due to Brexit uncertainty. Among the major emerging

economies, stable growth momentum is still the assessment for Brazil (102.2), Russia (99.5), and China's (99.2) industrial sector, while India's CLI (99.3) continues to point to easing growth momentum.

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