Yardeni Research

MORNING BRIEFING
January 28, 2020

Something To Fear

See the pdf and the collection of the individual charts linked below.

(1) When wishes come true. (2) P/E-led meltup increases risk of correction. (3) From nothing to fear to fearing a pandemic. (4) We are all virologists now. (5) China's autocrats: part of the solution or part of the problem? (6) China syndrome: a major health crisis has been waiting to happen. (7) Has technical picture been too bullish? (8) Too many winners? (9) Valuation models: different strokes for different folks. (10) Misery Adjusted P/E is neutral. (11) Sticking with 3500 S&P 500 target by year-end.

Strategy I: Risk Off. Beware of what you wish for. Joe and I started this year wishing that the stock market wouldn't melt up to our year-end target of 3500 for the S&P 500 well ahead of schedule. We were rooting for a gradual ascent to 3500 by the end of the year so that earnings would have time to catch up with the market's meltup since the index bottomed at 2351.10 on 12/24/18. It subsequently rose 41.6% to a record high of 3329.62 on 1/17 this year (*Fig. 1*).

It has been a P/E-led meltup. Since Christmas Eve 2018, the S&P 500 forward P/E soared from 13.5 to a high of 18.7 on 1/17 (*Fig. 2*). Over this same period, S&P 500 forward earnings is up just 2.2% (*Fig. 3*). While forward revenues increased 4.4% over this period (to yet another record high during the 1/16 week), the forward profit margin fell to 12.0% from 12.2% (*Fig. 4* and *Fig. 5*).

Until Friday, there was nothing to fear but nothing to fear, other than historically high valuation multiples. Since Friday, there has been something else to fear: that the coronavirus outbreak in China is spreading rapidly and turning into a pandemic, i.e., a global epidemic. The S&P 500 dropped 0.9% on Friday and 1.6% yesterday. The most unsettling news over the weekend was that people infected with the virus might show no symptoms for two weeks but still be contagious during that time.

That was not the case during the SARS outbreak of 2003 in China. It was quickly contained. No known transmission has occurred since 2004.

Our bet is that this too shall pass, though it could turn out to be the correction we anticipated as valuation multiples soared late last year and early this year. It could also be a minor panic attack. We don't expect that the pandemic will last long enough or be severe enough to cause a global recession. So we don't expect that Panic Attack #66 (if that's what it is) will morph into a bear market. However, as we noted yesterday, we aren't virologists. Admittedly, it is disturbing that the community of virologist is scrambling to assess how the coronavirus is transmitted and how it mutates.

Strategy II: China Syndrome. If Joe and I decide that the latest selloff is Panic Attack #66, then we will be anticipating Relief Rally #66. Stocks could quickly rebound to new record highs if the virus outbreak is contained and recedes. The Chinese government certainly is resorting to extreme measures to accomplish this pressing goal.

Another potential positive outcome of the outbreak would be if China's autocratic regime is forced by internal political forces to be less autocratic as a result of this health crisis. The Chinese people have been willing to give up many of their freedoms in exchange for better economic conditions. If health issues become a major source of popular discontent, the government's credibility and supremacy could be sorely tested.

China has been set up for a health crisis for some time. A 7/30/18 article in the *South China Morning Post,* titled "Fake data—the disease afflicting China's vaccine system," reported:

"China's vaccine production and distribution system is beset by fake data and fraudulent labelling, raising the risk of outbreaks of highly transmissible diseases, according to industry insiders and health experts. The assessment comes after Changchun Changsheng Bio-technology last week became the latest Chinese pharmaceutical company to [be] embroiled in a vaccine scandal.

"According to the State Drug Administration, Changsheng Bio-tech forged data on the effectiveness of its rabies vaccines and sold substandard DPT (diphtheria, whooping cough and tetanus) shots for children as young as three months old. The revelations undermine China's claims to have established a world-class 'whole-life cycle regulation system', controlling the research, production, distribution and administration of vaccines."

On Monday, the *Global Times*, the Communist Party's English language daily newspaper, editorialized that "[i]n the early days of SARS, reports were delayed and covered up. That kind of thing must not happen again in China. … We have made great strides in medicine, social affairs management and public opinion since 2003."

On Tuesday, our good friends at the Political Forum editorialized: "Maybe it's just us, but that sounds precisely like something that someone who is trying to cover stuff up would say." They opined: "First, the Chinese government is completely untrustworthy about anything, but especially about that which it thinks will make it look weak, inefficient, or otherwise unlikely to rule the world in the twenty-first century." (You can sign up for their daily commentary here.)

Strategy III: Stretched Technicals. Now let's review just how extended were some of the key technical metrics just before the news about the virus outbreak hit the stock market on Friday and yesterday:

(1) *The 200-day moving average of the S&P 500* rose to a record high of 3010 on Friday. The index itself exceeded that average by 11.0% on 1/17 when the index hit its record high (*Fig. 6*). That was the most overvalued reading since 2/1/18. If it drops to its moving average, that would be a 9.6% drop from the recent record high but would still leave the index above 3000. There has been an interesting positive correlation between this technical measure and the M-PMI (*Fig. 7*). However, the two have diverged recently, adding to the downside risk in the stock market.

(2) *Breadth measures* also have been bullishly overextended. For example, Joe reports that the percentage of S&P 500 companies trading above their 200-day moving averages peaked at 84.0% during 1/17, exceeding the 82.2% peak in January 2018 just before the subsequent selloff back then (*Fig. 8*).

Similarly, the percentage of S&P 500 companies with positive y/y price changes peaked at 90.2% during 12/20/19, slightly exceeding the early 2017 peak of 89.8% in this series (*Fig. 9*).

Strategy IV: Stretched Valuation Multiples. Now let's review just how extended were some of the key valuation metrics just before the news about the virus outbreak hit the market on Friday and yesterday:

(1) *Forward P/E and P/S.* In our discussion above, we focused on the forward P/E. It was at a cyclical high of 18.7, though well below the tech bubble high of 25.7 on 4/12/99. Nevertheless, if you are looking for trouble, then you'll find it in the S&P 500 forward price-to-sales ratio (P/S) (*Fig. 10*). It is simply the S&P 500 stock price index divided by forward revenues. Previously, we demonstrated that it very closely tracks the Buffett Ratio, which is the US equity market capitalization excluding foreign issues divided by nominal GNP. The forward P/S rose to a record high of 2.2 during the 1/16 week. That exceeds the tech bubble peak in the Buffett Ratio at 1.9 during Q1-2000.

(2) *Dividend yield.* Our valuation model based on S&P 500 dividends shows that stocks are fairly valued. During Q4-2019, the S&P 500 dividend yield was 1.8%. Our Blue Angels analysis for dividends creates hypothetical values for the S&P 500 stock price index using the actual S&P 500 dividend (on a four-quarter-trailing-sum basis) divided by dividend yields from 1.0% to 6.0% (*Fig. 11*). Interestingly, during the current bull market, the S&P 500 has been closely hugging its hypothetical value based on actual dividends and a 2.0% dividend yield! The index seems to be continuing that trend, though the recent rally has dropped the dividend yield somewhat.

(3) *MAPE.* We've found that there is a reasonably good inverse correlation between the forward P/E of the S&P 500 and the Misery Index. That makes sense to us. When we are miserable, we aren't in the mood to drive up the valuation multiple. When we are happy, we tend to become exuberant, driving up the P/E. However, a high P/E by historical standards may not necessarily reflect irrational exuberance if interest rates are historically low owing to subdued inflation. In other words, the current readings of the Misery Index are historically low and may justify P/Es that exceed the historical average.

Our homebrewed Misery Adjusted P/E (MAPE) index is the sum of the S&P 500 forward P/E and the Misery Index (*Fig. 12*). It averaged 23.8 from September 1978 through December 2019. Readings above (below) the average suggest that stocks are overvalued (undervalued). It was 24.1 during December, i.e., just 1% above the average. MAPE correctly warned that stocks were overvalued prior to the bear markets of the early 1980s and 2000s. It did not anticipate the last bear market, but that's because the problem back then was the overvaluation of real estate, not stocks.

By the way, we are sticking with our 3500 target for the S&P 500 by the end of this year.

CALENDARS

US: Tues: Consumer Confidence 128.0, Durable Goods Orders Total & Ex Transportation 0.9%/0.3%, Core Nondefense Capital Goods Orders & Shipments 0.1%/0.2%, Richmond Fed Manufacturing Index -3, S&P CoreLogic 20-City Composite Home Price Index 0.3%m/m/2.4%y/y. **Wed:** Advance Merchandise Trade Balance -$65.5b, Pending Home Sales, MBA Mortgage Applications, DOE Crude Oil Inventories, FOMC Rate Decision 1.63% (1.50%-1.75%), Rate on Excess Reserves 1.55%, Powell. (DailyFX estimates)

Global: Tues: Australia CPI 1.7% y/y, BOJ Summary of Opinions, Lane. **Wed:** Germany Gfk Consumer Confidence 9.6, Japan Consumer Confidence 39.5. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings (*link*): LargeCap's forward earnings rose to a third straight record high last week and its first since 9/20/19. SmallCap's rose for a tenth week in a row, and MidCap's was up for the ninth time in 10 weeks. These indexes began a forward-earnings uptrend during March but stumbled from July to November. LargeCap's forward earnings has risen during 36 of the past 50 weeks, MidCap's 28 of the past 46 weeks, and SmallCap's 27 of the past 44 weeks. While LargeCap's is at a record high now, MidCap's and SmallCap's are 3.0% and 4.4% below their October 2018 highs. Index changes for the SMidCaps at the end of 2019 helped MidCap's forward earnings improved from November's 18-month low, while SmallCap's is up from September's 17-month low. 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 2018 as y/y comparisons became more difficult. In the latest week, the rate of change in LargeCap's forward earnings rose to a seven-month high of 3.7% y/y from 3.3% and is up from a 38-month low of 1.0% in early December. That's down from 23.2% in September 2018, which was the highest since January 2011. MidCap's improved w/w to a four-month high of -1.4% y/y from -1.8%, 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 improved w/w to a seven-month high of 0.0% y/y from -0.2%; that's up markedly 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 during late 2018, but those forecasts are down substantially since then. Here are the latest consensus earnings growth rates for 2018, 2019, and 2020: LargeCap (22.7%, -0.2%, 9.6%), MidCap

(22.7, -6.2, 11.9), and SmallCap (22.4, -3.0, 15.8).

S&P 500/400/600 Valuation (*link*): Valuations were lower last week for these three indexes. LargeCap's forward P/E fell w/w to 18.5 from an 18-year high of 18.7. 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 compares to the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's forward P/E declined w/w to 17.1 from 17.4, which had matched its 22-month high of 17.4 in mid-December. 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 fell w/w to 17.3 from 17.7, and is down nearly a point from mid-December's 16-month high of 18.1. 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 is back below LargeCap's again. 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 the Q4 earnings season beginning to accelerate, earnings revisions activity is entering its typical buildup period as analysts begin to digest the release of results. The Q4 EPS forecast fell 3 cents w/w to $40.52. That represents a decline of 1.6% on a frozen actual basis and a drop of 0.5% y/y on a pro forma basis. That compares to a 0.3% 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 0.5% decline in Q4 as in Q3; that's up sharply from just three beating the S&P 500 during Q2. Four sectors are expected to post improved growth on a q/q basis during Q4: Communication Services, Financials, Tech, and Utilities. On an ex-Energy basis, the consensus expects earnings to rise 2.4% y/y in Q4. That compares to ex-Energy gains of 2.2% in Q3, 3.9% in Q2, and 3.0% in Q1 but is well below ex-Energy's 25.0% and 14.2% y/y gains in Q3-2018 and Q4-2018, respectively. Here are the latest Q4-2019 earnings growth rates versus their final Q3-2019 growth rates: Utilities (13.1% in Q4-2019 versus 6.7% in Q3-2019), Financials (11.1, 2.6), Health Care (6.8, 8.8), Real Estate (3.9, 5.9), Communication Services (3.0, -1.4), Information Technology (2.5, -1.7), Consumer Staples (1.6, 3.7), Industrials (-6.4, 3.4), Materials (-12.0, -10.9), Consumer Discretionary (-11.5, 1.8), and Energy (-43.8, -37.8).

S&P 500 Q4 Earnings Season Monitor (*link*): With over 17% of S&P 500 companies finished reporting revenues and earnings for Q4-2019, revenues and earnings are beating the consensus forecasts by 1.1% and 4.9%, respectively. Those are in line with their respective 1.0% and 4.4% beats at the same point in Q3, but the percentages of companies showing a positive earnings surprise is lower. On a positive note, y/y earnings growth is exceeding revenue growth for the first time since Q4-2018. Of the 87 companies in the S&P 500 that have reported through mid-day Monday, 69% exceeded industry analysts' earnings estimates. Collectively, the small sample of reporters has a y/y earnings gain of 6.4%. On the revenue side, 64% of companies beat their Q4 sales estimates so far, with results 3.4% higher than a year earlier. Overall Q4 earnings growth results are positive y/y for 66% of companies, and revenues have risen y/y for 74%. These figures will change markedly as more Q4-2019 results are reported in the coming weeks, but what companies say about their growth and margin prospects for 2020 will be investors' main focus.

US ECONOMIC INDICATORS

New Home Sales (*link*): New home sales in December unexpectedly fell for the third consecutive month, depressed by a shortage of more affordable homes. December sales sank 0.4% m/m and 4.3% over the three-month period, to 694,000 units (saar). Still, December sales were 23.0% above the December 2018 level, and the rate of increase for all of 2019 was 10.3%, a jump to 681,000 units—the highest since 2007—led by double-digit gains in the South and West. The supply of new homes on the market was at 327,000 units in December, down from 346,000 units at the end of 2018, with the months' supply at 5.7, down from 7.4 months over the comparable periods. Looks like more supply is on the way: Single-family housing starts advanced for the sixth time in seven months in December, by 11.2% m/m and 29.6% over the period, to 1.055mu (saar)—its first reading above 1.0mu since July 2007. Existing home sales data show demand is strong: Single-family sales jumped to a 22-month high of 4.92mu (saar) in December, and grew at a double-digit pace y/y.

Regional M-PMIs (*link*): Four Fed districts have now reported on manufacturing activity for January—Philadelphia, New York, Dallas, and Kansas City—and show growth picked up this month. Thanks to a sharp acceleration in the Philly Fed region, the composite (to 5.2 from -0.6) index posted its best performance since last May. By region: Philadelphia (17.0 from 2.4) recorded its strongest growth in eight months; Kansas City's (-1.0 from -5.0) activity continued to contract, though at a slower pace, while Dallas' (-0.2 from -3.2) looked poised to expand after contracting for four months. Meanwhile, New York's (4.8 from 3.3) measure remained stalled at a sluggish rate. The new orders index (10.1 from 0.4) shows billings this month expanded at the best pace in over a year, led by strong growth in both the Philly (18.2 from 11.1) and Dallas (17.6 from 1.6) regions; New York (6.6 from 1.7) orders accelerated at a faster pace, while Kansas City's (-2.0 from -13.0) contracted at a slower pace. Employment (8.6 from 6.6) data show manufacturers hired at a slightly faster pace this month, with Philadelphia (19.3 from 16.8) factories hiring at double the pace of New York's (9.0 from 10.4). Meanwhile, Kansas City (4.0 from -7.0) manufacturers added to payrolls for the first time since last June, while Dallas' (1.9 from 6.2) showed little growth.

GLOBAL ECONOMIC INDICATORS

Germany Ifo Business Climate Index (*link*): "The German economy is starting the year in a cautious mood," according to Clemens Fuest, president of Ifo, as business confidence slipped for the first time in five months. Germany's Ifo Business Climate Index sank to 95.9 this month after posting a six-month high of 96.3 at the end of 2019; it bottomed at 94.5 in August. The present situation component increased for the fourth time in five months since bottoming in August, climbing from 97.7 to 99.9 over the period. Meanwhile, the expectations component took a step back, dipping to 92.9 this month, after climbing steadily from 90.9 in September to a six-month high of 93.9 last month. By sector, manufacturing was a bright spot, with sentiment showing signs of recovery as both the present situation and future outlook improved. The present situation (to 6.3 from 1.0) component posted its first increase in 20 months (and the biggest since January 2018), while the expectations (-9.2 from -10.9) component improved for the fourth straight month since bottoming at -17.0 in September. Meanwhile, a drop in the service-sector's expectations (0.1 from 5.3) component pushed the overall index down to 18.7 from December's seven-month high of 21.3; the present situation component continued to climb, from 32.1 in August to 39.0 this month. Sentiment in the construction industry deteriorated further, with both the present (38.0 from 43.9) and expectations (-7.5 from -5.3) components continuing to slide.

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