



MORNING BRIEFING

January 3, 2017

Rogue One

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

(1) Prequels and sequels. (2) Going rogue on 2017 earnings outlook. (3) Does it matter whether tax cuts start in 2017 or 2018? (4) S&P 500 forward revenues and earnings rising to record highs. (5) Energy industry's recession is over, and it didn't spill over to the broader economy. (6) Consumer optimism booming since Election Day. (7) Trump's "America First" inspired by Lord Palmerston. (8) Radical regime change: From community organizers to dealmakers. (9) Two kinds of rogues. (10) May the force be with us. (11) "Rogue One" (-).

Strategy I: The Recession Is Over. Below, I review the movie "Rogue One," the latest of the prequels and sequels in the "Star Wars" saga. Once again, "a long time ago in a galaxy far, far away," rebels are fighting the storm troopers of the evil Empire. It is all very predictable and boring. It would have been a very good opportunity to take a nap, but the Dolby sound was deafening. Nevertheless, I am glad I saw it because it gave me a good title for this *Morning Briefing*.

Joe and I went rogue on August 22 when we [declared](#) that the earnings recession was over. We extended our roguery on December 13 when we [raised](#) our 2017 S&P 500 earnings estimate from \$129 per share to \$142, increasing the predicted earnings growth rate from 8.9% to 19.8%. We did so to reflect our expectations that the incoming White House administration led by President-elect Donald Trump will succeed in lowering the statutory corporate tax rate from 35% to 15%.

The most frequent pushback we've received on this forecast is that the corporate tax cut will be a part of a much bigger package of tax reforms that won't be thrashed out until this summer, at the earliest. That's true, but we are assuming that it will be retroactive to the start of this year. Since Election Day, the stock market seems to be discounting the same outlook.

Even if we won't know for sure until the middle of this year whether the tax cuts start at the beginning of 2017 or 2018, by then the market will be increasingly discounting 2018. In other words, it doesn't matter much for the stock market whether the tax cuts are retroactive. All that matters is that they happen within the next 12 months and that they are as significant as currently planned by the incoming administration. Now consider the following relevant observations:

(1) *Industry analysts starting to go rogue too?* Using our weekly "Earnings Squiggles," Joe and I monitor the consensus earnings expectations of the industry analysts who cover the S&P 500 companies. The estimates for 2016 and 2017 have been falling since we started tracking them during September 2014 and September 2015 ([Fig. 1](#)). They both had noticeable downward trends since then, which is a very typical pattern since analysts have a tendency to be overly optimistic and are forced to become more realistic as actual earnings results approach.

The consensus estimate for 2017 is down to \$132.67, implying a growth rate of 12.4% over 2016. Analysts clearly haven't started raising their estimates to reflect a possible corporate tax cut this year. They won't do so until company managements provide them with guidance on this matter, which won't happen until the tax reform package is actually legislated. Only then can companies assess what their

effective tax rates will be, which will depend not only on the new lower statutory rate but also on which, if any, deductions and exemptions will be eliminated as a quid pro quo for the lower rate.

We started tracking the 2018 Earnings Squiggle for the S&P 500 during September of last year. So far, the estimate has been holding up around \$148. If it remains stable at this lofty level in coming weeks, that might suggest that while industry analysts won't raise their estimates for 2017 without company guidance, they might be willing to signal their expectations that tax reform will be bullish for earnings in the not-too-distant future by sticking with their current estimate for 2018.

(2) *Industry analysts upbeat on S&P 500 revenues.* We also keep track of Revenues Squiggles. For the S&P 500, they show that revenues expectations for 2016 and 2017 stopped falling and have been stable since the start of the year ([Fig. 2](#)). That corresponds with the rebound in the price of oil at the start of the year, which stopped the Energy sector from weighing on overall S&P 500 revenues. Industry analysts currently project that S&P 500 revenues will grow 5.8% in 2017 and 4.7% in 2018. Joe and I think that these optimistic growth rates are possible.

(3) *Forward revenues and earnings confirm Energy-led recession is over.* S&P 500 forward revenues--which is a time-weighted average of the current-year and coming-year estimates--bottomed at the beginning of this year. It has been rising into record-high territory since the week of October 6 ([Fig. 3](#)). This is a good omen for actual quarterly revenues. The same can be said for forward earnings, which also has been rising into record territory since the week of October 6 ([Fig. 4](#)). All these developments confirm our view that the Energy-led earnings recession is over and that the outlook for earnings has turned brighter again.

By the way, it is interesting to note that forward earnings has been rising faster than forward revenues since the start of the year ([Fig. 5](#)). We divide the former by the latter to calculate an implied forward profit margin, which has been rising since the start of the year ([Fig. 6](#)). Again, this augurs well for the actual profit margin.

(4) *The end of energy industry's rolling recession.* In late 1985 through early 1986, the price of a barrel of West Texas crude oil plunged by 67% ([Fig. 7](#)). That caused a severe recession in the oil patch, particularly in Texas. There were widespread concerns that it would spill over into the rest of the economy. Debbie and I didn't think so and dubbed it a "rolling recession," which rolled through just one important industry. The recession didn't spread beyond the oil patch.

The price of a barrel of West Texas oil plunged 76% from the summer of 2014 through early 2016. Again, there were widespread concerns about an economy-wide recession that might be exacerbated by a financial crisis. Credit spreads widened dramatically: The gap between the yields on high-yield corporate and the 10-year Treasury bond jumped from a 2014 low of 253bps during June to peak at 844bps on February 11, 2016 ([Fig. 8](#)). Once again, Debbie and I believed it was another recession rolling just through the oil patch. Sure enough, real GDP continues to rise to record highs, and the credit spread was as low as 362bps early last week, which was the lowest since October 6, 2014.

Interestingly, while the US oil rig count plunged along with the price of oil, US oil field production fell just 12% from its most recent peak to trough, and has recovered in recent weeks back to 8.8mbd, 9% below its most recent peak ([Fig. 9](#)). The message from US frackers to the Saudis and Russians seems to be: "Thanks for cutting your production so that we can continue to produce lots of oil!" At the end of last year, the US petroleum industry's inventory-to-sales ratio remained at the highest reading since 1990 ([Fig. 10](#)).

(5) *Trump boosts consumers' already upbeat expectations.* While President-elect Trump remains highly

controversial, there's no debating that his policy proposals are boosting consumer optimism. Debbie and I average the monthly Consumer Sentiment Index and the Consumer Confidence Index to derive our Consumer Optimism Index (COI) ([Fig. 11](#)). Our index jumped from 94.0 during October to 106.0 during December, the best reading since December 2000. Over this two-month period, the COI expectations component is up a whopping 16.1 points to 97.5, the highest since July 2004, while its current conditions component is up 5.9 points to 119.0, at its highest readings since July 2007.

Strategy II: Radical Regime Change. "Nations have no permanent friends or allies; they only have permanent interests." That famous quote has been attributed to many political leaders. Apparently, it is a short version of a lengthier excerpt from a [speech](#) by Henry John Temple--a.k.a. Lord Palmerston--in the British House of Commons House on March 1, 1848, to wit:

"We have no eternal allies, and we have no perpetual enemies. Our interests are eternal and perpetual, and those interests it is our duty to follow. When we find other countries marching in the same course, and pursuing the same objects as ourselves, we consider them as our friends, and we think for the moment that we are on the most cordial footing; when we find other countries that take a different view, and thwart us in the object we pursue, it is our duty to make allowance for the different manner in which they may follow out the same objects. It is our duty not to pass too harsh a judgment upon others, because they do not exactly see things in the same light as we see; and it is our duty not lightly to engage this country in the frightful responsibilities of war, because from time to time we may find this or that Power disinclined to concur with us in matters where their opinion and ours may fairly differ. That has been, as far as my faculties have allowed me to act upon it, the guiding principle of my conduct."

President-elect Donald Trump has shortened this excerpt to "Make America Great Again." An even shorter version is his "America First" meme. On April 27 at the Mayflower Hotel in Washington, DC, he presented a major foreign policy [speech](#). He outlined a general vision for international relations that would reconfigure American responsibilities abroad to "put Americans first."

"My foreign policy will always put the interests of the American people and American security above all else," Trump said. "That will be the foundation of every single decision that I will make. America First will be the major and overriding theme of my administration."

Since Election Day, investors have been learning quickly not to underestimate Donald Trump. That became especially obvious the next day, when we all learned that he won with Republican majorities in both houses of Congress. That doesn't mean that he will get his way on everything he proposed during the campaign. However, he has already backed off from some of his extreme positions. He remains committed to his radical economic proposals, including reforming the tax code and reducing regulations on business. He is likely to have plenty of support in Congress for such measures.

Trump's Cabinet picks confirm that he remains staunchly committed to a conservative economic and foreign policy agenda consistent with America First. As I wrote on 12/16, "While it is true that Trump and most of his designated Cabinet appointees have no government experience, as charged by liberal critics, most of Trump's picks are extremely successful business people. Many of them are dealmakers. That's quite a change from the past eight years, when conservatives charged that the government was run by community organizers."

It's actually much more than "quite a change." It is a radical regime change bordering on revolutionary. Consider the following:

(1) The conservative rebels have brought down the Progressive Empire without firing a shot thanks to our remarkable constitutional system. On Election Day, Trump buried the Bush and Clinton dynasties.

He also is about to bury the Obama legacy.

(2) Election Day might have marked the revival of the Old Normal business cycle and the end of the New Normal, which was characterized by secular stagnation. Debbie and I raised our forecast for real GDP next year on a Q4/Q4 basis from 3.0% to 3.5% on our expectations that Trump's tax cuts and deregulation will boost economic activity. We also increased our earnings growth rate forecast, as noted above, and raised our S&P 500 target from 2300-2400 to 2400-2500.

(3) In response to Trump's decisive victory, we also raised our target ranges for the 10-year Treasury bond yield to 2.00%-2.50% through mid-2017 and to 2.50%-3.00% during the second half of next year. This yield has risen 57bps since Election Day ([Fig. 12](#)).

(4) Election Day might have marked the end of the Age of Central Banks. During the summer and fall, Fed officials have been calling for more fiscal stimulus to boost economic growth so that they could proceed to normalize monetary policy. Trump is likely to fulfill their wish even though the more liberal members of the FOMC most likely wished for a different outcome on Election Day.

For the past nine years, the economic outlook and the prospect for the stock market have hinged almost entirely on the ultra-easy monetary policies of the Fed and the other major central banks. Now monetary policy likely will matter less, while fiscal policy, which hasn't mattered much, will matter much more.

It is interesting to recall the warnings of the bears that the bull market in stocks since 2009 was artificially driven by the Fed's various QE programs. They predicted that when the Fed stopped buying bonds, stock prices would dive. Their favorite chart showed the close correlation between the S&P 500 and the Fed's holdings of bonds ([Fig. 13](#)). The Fed terminated its QE program at the end of October 2014. As predicted by the pessimists, the S&P 500 stopped going up in 2015 through the summer of 2016. However, it went on to make new record highs after Election Day.

(5) The Oxford dictionary's definition of "rogue" is "a dishonest or unprincipled man." A similar alternative definition is "a person who behaves in an aberrant or unpredictable way, typically with damaging or dangerous effects." Lots of people think that describes Trump. In the movie, "Rogue One" is the name that the rebels, who are the "good guys," give their spaceship. We are reserving judgment on which version of rogue Trump will be. For now, we are giving him the benefit of the doubt and betting that he will be a surprisingly good president. Admittedly, we will be surprised if he is, given his quirky style.

May the force be with us.

Movie. "Rogue One" (-) ([link](#)) was really dull because it is the seventh movie in the "Star Wars" series of flicks about the never-ending wars between the freedom-loving rebels and their totalitarian adversaries, who rule the Empire. I didn't give it my worst rating out of respect for the passing away of Carrie Fisher. She was Princess Leia in the original three films. She makes a digitally recreated appearance in this film, as does Peter Cushing, who died in 1994, after playing the nefarious ally of Darth Vader and the commander of the Death Star. In the future, movie studios will save lots of money by casting digitally recreated dead stars in their movies. My wife, who is a fan of the intergalactic series, also pressured me to raise my rating, observing that fans appreciate how this prequel set the stage for the very first movie.

CALENDARS

US. Tues: ISM M-PMI 53.8, Construction Spending 0.6%. **Wed:** ADP Employment 172k, Total & Domestic Motor Vehicle Sales 17.7mu/13.8mu, MBA Mortgage Applications, Gallup US Job Creation Index and US Consumer Spending Measure, FOMC Minutes. (Bloomberg estimates)

Global. Tues: Germany CPI 0.6%/m/m/1.4%/y/y, Germany Unemployment Change & Unemployment Rate -5k/6.0%, China Markit/Caixin Composite & NM-PMIs. **Wed:** Eurozone CPI Headline & Core Flash Estimates 1.0%/0.8% y/y, Eurozone, Germany, France, and Italy Composite PMIs 53.9/54.8/52.8/53.0, Eurozone, Germany, France, and Italy NM-PMIs 53.1/53.8/52.6/52.6, Japan Composite & NM-PMIs. (DailyFX estimates)

STRATEGY INDICATORS

Global Stock Markets Performance ([link](#)): The 9.2% gain for the US MSCI index in 2016 was up from a 0.8% decline in 2015, but its global ranking dropped to 16/49 from 11/49 in 2015. Twenty-five of the 49 markets rose in 2016, up from only eight rising in 2015. The 5.6% gain for the All Country World MSCI Index was up from a 4.3% decline in 2015. The All Country World ex-US MSCI rose just 1.7% for the year, but that's up from an 8.0% decline in 2015. All regions rose in 2016 except EMU and EAFE, compared to 2015 when all regions fell. EM Eastern Europe was the best performer with a gain of 33.0%, followed by EM Latin America (27.9), EMEA (18.1), BRIC (9.5), and EM Asia (3.8). EAFE and EMU were the worst-performing regions in 2016, with declines of 1.9% and 1.2%, respectively. Among countries, the best performers in 2016 were Brazil (61.3), Peru (53.8), Russia (48.9), Pakistan (32.7), and Hungary (32.3); the worst performers were Israel (-26.1), Denmark (-17.2), Italy (-13.3), Greece (-13.2), and Egypt (-12.8).

S&P 1500/500/400/600 Performance ([link](#)): The S&P LargeCap index rose 9.5% for the year, but trailed the SuperComposite (10.6%), MidCap (18.7), and SmallCap (24.7) indexes. During 2015, these indexes were all negative for the year: LargeCap (-0.7), SuperComposite (-1.0), MidCap (-3.7), and SmallCap (-3.4). Thirty-two of the 33 sectors rose in 2016--all but LargeCap Health Care (14.4)--up from 10/30 sectors rising in 2015 before Real Estate became a new sector. The best-performing SuperComposite sectors and their changes for 2016: Energy (23.7), Financials (21.5), Materials (19.1), Industrials (17.8), Telecommunication Services (17.8), Utilities (13.7), and Information Technology (13.0). The weakest performers were Health Care (-3.6), Consumer Staples (3.1), Real Estate (3.3), and Consumer Discretionary (5.0).

S&P 500 Sectors and Industries Performance ([link](#)): The S&P 500 rose 9.5% in 2016 as 10 of its 11 sectors moved higher; that compares to four sectors rising in 2015, when the S&P 500 fell 0.7%. The best performers of 2016 among sectors: Energy (23.7%), Financials (20.1), Telecom (17.8), Industrials (16.1), Materials (14.1), Utilities (12.2), and Tech (12.0). The year's worst performers: Health Care (4.4), Real Estate (slightly above 0.0), Consumer Staples (2.6), and Consumer Discretionary (4.3). Last year marked the first time in three years that Telecom and Energy rose for the year as a whole, with Telecom posting its best performance in 10 years and Energy in its best in nine. Last year was also the first time in eight years that Health Care fell for the year. Three sectors ended the year higher for an impressive eighth straight year: Consumer Discretionary, Consumer Staples, and Information Technology.

Commodities Performance ([link](#)): Eighteen of the 24 commodities that we follow rose in 2016, up from three rising in 2014. The S&P GSCI Commodities index rose 27.8%, better than its 25.5% decline in 2015, but remains down 55.3% from its record high in 2008. Energy-related commodities dominated the best performers in 2016: Zinc (60.1%), Natural Gas (59.3), Heating Oil (53.8), GasOil (51.0), Brent Crude (50.8), Crude Oil (45.0), and Unleaded Gasoline (31.5). Food-related commodities dominated the worst performers in 2016: Cocoa (-33.8), Feeder Cattle (-23.6), Live Cattle (-15.2), Wheat (-13.2),

Kansas Wheat (-10.7), and Corn (-1.9). Gold rose 8.6% for the year, recovering from a 10.5% decline in 2015.

Assets Sorted by Spread w/ 200-dmas ([link](#)): Spreads between prices and 200-day moving averages (200-dmas) rose last week for 16/24 commodities, 4/9 global stock indexes, and 3/33 US stock indexes. Fifteen commodities trade above their 200-dmas, up from 13 a week earlier as Lean Hogs and Sugar turned positive w/w. Commodities' average spread rose to 3.8% from 3.1%. Natural Gas trades 33.9% above its 200-dma, which is the highest of all commodities and all assets. Sugar had the best w/w gain relative to its 200-dma among all assets last week, rising 6.7ppts to 0.5%. Cocoa (-24.8%) trades at the lowest of all commodities and all assets relative to its 200-dma. Nickel was the worst performer among all assets last week, falling 4.4ppts to 0.4%. The global indexes trade an average of 5.8% above their 200-dmas, up from 4.9% above in the prior week. All nine of the global indexes trade above their 200-dmas, up from eight a week earlier as Indonesia turned positive w/w. Japan (12.8) leads the global indexes, but was the group's worst performer last week as it lost 2.2ppts. Indonesia performed the best of its country peers last week as it rose 5.1ppts to 3.2%. South Korea (1.0) is trading at the lowest relative to its 200-dma of the global assets. US indexes trade an average of 7.5% above their 200-dmas, with 29 sectors above, down from an 8.9% average a week earlier, when 28 sectors were above. SmallCap Materials leads all US stock indexes at 23.6% above its 200-dma, but MidCap Real Estate was last week's best performer among US stock indexes, as it improved 1.6ppts w/w to 0.3%. LargeCap Real Estate (-3.4) still trades the lowest among US indexes relative to its 200-dma, but SmallCap Energy was last week's worst performer among US stock indexes as it fell 3.8ppts to 22.8%.

S&P 500 Technical Indicators ([link](#)): The S&P 500 remained in a Golden Cross last week for a 36th week (after 17 weeks in a Death Cross) even as the index's short- and long-term technical pictures weakened. Its 50-day moving average (dma) improved to an eight-week high of 2.8% above its 200-dma from 2.5% a week earlier and a six-month low of 1.97% the week before that. That's down from a 30-month high of 5.4% in mid-September, but up from a 52-month low of -4.5% in early March. The S&P 500's 50-dma moved higher for a seventh week after six weekly declines, and the index closed the week above its 50-dma for a seventh week after nine weeks below. However, the S&P 500 slipped to 1.5% above its rising 50-dma from 3.5% and a 38-week high of 4.8% above its rising 50-dma on December 13; that compares to a 52-month high of 6.2% on March 21 and a five-month low of -7.8% in mid-January. The S&P 500's bounce off its 200-dma in early November is losing steam: The index fell to 4.6% above its rising 200-dma from 6.1% the week before and from a three-month high of 6.9% above its rising 200-dma on December 13. That compares to a 20-month high of 7.1% in mid-August and a six-month low of -10.0% in mid-February. The 50-dma and 200-dma both have risen together for a seventh week after falling for eight weeks.

S&P 500 Sectors Technical Indicators ([link](#)): The short-term and long-term technical pictures weakened for 10 of the 11 S&P 500 sectors last week. However, all 11 sectors still trade above their 50-day moving averages, unchanged from a week earlier. That's a big turnaround from eight weeks ago, when all 11 sectors traded below their 50-day moving averages (dma) for the first time since December 11, 2015. Seven of the 11 sectors were above their 200-dmas last week, also unchanged from a week earlier. The four sectors still trading below their 200-dmas: Consumer Staples, Health Care, Real Estate, and Utilities. Only six sectors are in a Golden Cross now, with 50-dmas higher than their 200-dmas. The Golden Cross club members: Consumer Discretionary, Energy, Financials, Industrials, Information Technology, and Materials. All 11 had been in a Golden Cross during a 21-week streak that ended October 24, the longest such stretch since October 2014. Eight of the 11 sectors have rising 50-dmas and nine have rising 200-dmas, unchanged from a week earlier. These three sectors still have falling 50-dmas: Consumer Staples, Health Care, and Real Estate. Consumer Staples and Real Estate are the only two sectors with a falling 200-dma.

US ECONOMIC INDICATORS

Consumer Confidence Index ([link](#)): Consumer confidence blew past forecasts again in December, surpassing pre-recession levels. The Consumer Confidence Index surged from 100.8 in October to 113.7 in December--the highest since August 2001! It's up 21.3 points from this year's low of 92.4 in May. According to the Conference Board, the gain in confidence was entirely driven by rising expectations, led by optimism among older Americans. The expectations component jumped 19.5 points over the two-month period to 105.5--the highest reading since December 2003. The present situation component slipped to 126.1 last month after rising from 123.1 to 132.0 in November. Consumers' six-month job outlook has soared since the election, with those expecting more jobs (21%) exceeding those expecting fewer jobs (14) by the largest margin since May 2002. Meanwhile, the current job outlook deteriorated slightly last month: "jobs plentiful" (to 26.9% from 27.8%) continued to bounce around cyclical highs, while "jobs hard to get" (22.5 from 21.2) ticked up from November's cyclical low.

Consumer Sentiment Index ([link](#)): The so-called Trump-bump pushed consumer confidence to a new cyclical high in December. The Consumer Sentiment Index rebounded from a 13-month low of 87.2 in October to 93.8 in November and 98.2 in December--surpassing the previous cyclical high of 98.1 in January 2015. Richard Curtin, the Surveys of Consumers' chief economist, noted that 18% of consumers mentioned the expected favorable impact of Trump's policies on the economy. That was twice as high as the prior peak of 9% in 1981 when Ronald Reagan took office. The expectations component climbed 12.7 points in the two months through December to a 23-month high of 89.5; the present situation rose 8.7 points over the period to 111.9, the highest since July 2005. (The final December reading was slightly above the mid-month reading of 98.0, with the expectations component [88.9] above its reading and the present situation [112.1] reading below.)

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