



## MORNING BRIEFING

January 5, 2017

### Leading from Behind

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

(1) Stay home, go global, or emerge? (2) Trump favors “Stay Home” investment strategy. (3) Commodity prices seem to matter more for emerging markets than does the Fed or the dollar. (4) Asian economies doing well now, but facing Trump tweets on trade. (5) Profits rising in China. (6) South Korea has a political crisis, while India has a currency crisis. (7) Taiwan’s M-PMI confirming upturn in tech business. (8) Brazil remains in deep recession, while Mexico may be starting to stumble on troubles north of the border. (9) Jackie explains Health Care’s wounded performance. (10) Is a shortage of new drugs pushing up prices of old drugs? (11) Drug distributors getting squeezed.

**Emerging Economies: Looking Up.** Yesterday, Debbie and I reviewed December’s global M-PMI story focusing on the advanced economies. Today, let’s have a closer look at the overall emerging economies story. While we continue to favor our “Stay Home” investment strategy, we want to be open-minded about the “Go Global” alternative, even though the election of Donald Trump as president certainly augurs for another four years of staying close to home.

On balance, the Emerging Markets MSCI stock price index performed remarkably well during 2016 despite the Fed’s latest rate hike at the end of last year, which had been widely expected for a while. It rose 7.1% in local currencies and 8.6% in US dollars ([Fig. 1](#)). That was not the case during 2015, when investors started to discount the expectation that the Fed would begin to raise the federal funds rate for the first time during the current economic expansion. The stock index plunged 8.0% in local currencies and 17.0% in US dollars during 2015.

While EM investors were relieved that it was one-and-done for the Fed last year, the stock price index still slumped late last year. Nevertheless, EM stocks are holding up remarkably well given that the Fed is expected to raise the federal funds rate two or three times this year. The same story holds true for the Emerging Markets MSCI currency index, which plunged 7.1% during 2015 but rose 3.5% last year despite a yearend slump ([Fig. 2](#)).

While US monetary policy has a significant impact on the stock prices, bond yields, and currencies of emerging economies, so does the trend of commodity prices. Indeed, the CRB raw industrials spot price index remains highly correlated with the Emerging Markets MSCI stock price index, especially in US dollars ([Fig. 3](#) and [Fig. 4](#)). The index also had been highly correlated with the inverse of the JP Morgan trade-weighted dollar, but that correlation has broken down significantly since mid-2014 ([Fig. 5](#) and [Fig. 6](#)).

The bottom line is that commodity prices still seem to be the key drivers of emerging markets right now, more so than ever. Investors should be aware therefore that when they invest in EM stocks, bonds, and currencies, they are actually investing in commodities. That’s an important insight, since it is widely believed that the EMs are emerging into more developed economies that depend increasingly on their emergent middle classes for growth and earnings. Nevertheless, there are certainly plenty of opportunities for stock pickers to pick stocks in the EMs that are not highly correlated with commodity

prices and can go up on good fundamentals.

Now let's review some of the latest EM economic indicators, focusing on December's M-PMIs:

(1) *Global*. As we observed yesterday, December's global M-PMI rose to 52.7, the highest since February 2014, led by the index for the developed economies, which rose to 54.0 ([Fig. 7](#)). The emerging markets M-PMI continues to lag behind, though it rose to 51.2, the highest since July 2014. The volume of EM exports remained on an uptrend and in record-high territory last year through October ([Fig. 8](#)).

(2) *Asia*. Under the incoming Trump administration, Asia's emerging economies face an uncertain future with the US. President-elect Donald Trump wants to reduce imports from the region, presumably to create jobs in the US. He has threatened to withdraw from the Trans-Pacific Partnership during his first day in office. However, for now, December's M-PMIs showed an upbeat picture for many Asian EMs.

(3) *China*. China's manufacturing activity continued to improve last year. The official M-PMI was at 51.4 in December, little changed from November's 51.7, which was the highest since July 2014. According to a 12/27 [press release](#) from the National Bureau of Statistics of China, industrial profit rose 14.5% y/y during the first 11 months of 2016. Of the 41 industrial divisions, 30 of them increased their profits on a y/y basis.

(4) *South Korea*. The recent downturn in South Korean manufacturing continued to ease, with the M-PMI rising from 48.0 to 49.4 thanks to higher exports. The political upheaval created by President Park Geun-hye impeachment trial did not seem to affect the economy. However, the Korean economy faces a period of uncertainty until the political turmoil is resolved.

(5) *Taiwan*. Taiwan's M-PMI was the best performer among Asian economies, rising to 56.2 in December. Higher demand in the tech sector is leading the improvement in manufacturing, according to a 12/22 Bloomberg [article](#). The upward trend in the tech sector may continue further with the [opening](#) of the Taiwan "Asian Silicon Valley" at the end of 2016.

(6) *Vietnam*. Continued strong foreign direct investment (FDI) into Vietnam helped the economy to defy the global manufacturing crunch. Reuters [reported](#) on 12/27 that during December, Vietnam had a 9% y/y increase in FDI. The country's M-PMI was 52.4 in December. China's increasing labor cost has more Chinese apparel makers turning to Vietnam for cheaper labor, according to a 12/21 Nikkei [article](#). Undoubtedly, other Chinese industries are also moving to Vietnam for the same reason.

(7) *Singapore*. Singapore's M-PMI rose from 50.2 to 50.6 in December, climbing from its low for the year of 48.5 in February. The improvement in electronic and biomedical manufacturing saved Singapore from falling into a technical recession.

(8) *Thailand*. Thailand's M-PMI improved significantly from 48.2 to 50.6 in December. Despite a temporary decrease in economic activity during November due to the passing of Thailand's king, exports remain on an uptrend.

(9) *India*. There was a significant contraction in India's M-PMI in December to 49.6 from 52.3. This is likely to be a short-term problem caused by the recent government-mandated ban on large-denomination currency notes in an effort to fight corruption and tax avoidance. The cash shortage led to temporary lower economic activity. Overall, India's economy remains strong.

(10) *Latin America*. Brazil remains in a severe manufacturing recession notwithstanding the rebound in commodity prices. The country's M-PMI was 45.2 in December, down from 46.2 the previous month. It has been below 50.0 since February 2015. On the other hand, Mexico's M-PMI has exceeded 50.0 since October 2013. However, it fell to 50.2 during December, the lowest reading since moving into expansionary territory. It is bound to get weaker as Trump continues to demand that US manufacturers produce less in Mexico and more in the US.

(11) *Eastern Europe*. Manufacturing activity in the Czech Republic, Hungary, Poland, and Russia continues to grow. Poland's M-PMI increased from 50.2 to 54.3 in the two months through December. Riding on the improvement in the commodity market, Russia's M-PMI hit a 69-month high of 53.7.

**Sector Focus: Health Care.** It wasn't supposed to turn out this way. Hillary Clinton was supposed to be bad for health care stocks, while Donald Trump was supposed to be good for them. He won, she lost, and so did health care stocks. The S&P 500 Health Care stock price index was expected to bounce back from its miserable year and end 2016 with a bang. Well, the bang was short-lived. After a brief celebration, the Health Care sector relapsed to end the year down 4.4% compared to the 9.5% rise in the S&P 500 ([Fig. 9](#)).

After Election Day, investors may have taken a second look at what President-elect Donald Trump said about the drug industry during the course of the campaign. In the past, he has proposed opening the US market to low-cost drug imports. Another Trump idea: Having Medicare directly negotiate drug prices. And, in an interview that was part of *Time* magazine's "Person of the Year" 12/7 [article](#), Trump said, "I'm going to bring down drug prices. ... I don't like what has happened with drug prices."

And just like that, the industry's faint glimmer of hope was snuffed out. The S&P Health Care sector has had two tough years, gaining only 0.6% over 2015 and 2016, making it the second-worst-performing sector over that two-year period. After such a dismal performance, the sector has the third-lowest forward P/E of the 11 S&P 500 sectors. At 14.4 as of December 29, Health Care's P/E is almost three percentage points lower than that of the S&P 500 and only slightly ahead of Financials' (14.1) and Telecom's (14.2) ([Fig. 10](#)).

Health Care's share of S&P 500 earnings also is almost three percentage points more than its capitalization share in the S&P 500 ([Fig. 11](#)). The recent underperformance follows a four-year period, from 2011 through 2014, when the sector did extraordinarily well, gaining 117.1%. Over those four years, Health Care was the top-performing sector, far outperforming the S&P 500's 63.7% return over the same period. A similar run in the late 1990s was followed by 10 years of consolidation. Has enough time passed for the industry to make a comeback? Much will depend on the policies coming out of the White House. Here's a look at four of the industries driving the sector's performance:

(1) *Evil drug empire*. The pharmaceutical industry has been tarred and feathered for much of the past two years for seeming to raise drug prices arbitrarily. Valeant Pharmaceuticals and Turing Pharmaceuticals (led by maniacal Martin Shkreli) may have been the poster children for bad behavior, but the problem is that even "traditional" drug companies have been hiking prices to bolster profits. As a result, the industry has become a punching bag for politicians, and its reputation has been badly bruised.

The S&P 500 Pharmaceuticals industry index fell 4.0% last year. It is up 3.7% since the election, but lagging the S&P 500's 5.5% gain. The S&P 500 Biotechnology industry index fared even worse, with a 14.4% drop in 2016 as a whole and gaining only 4.2% since Trump got the nod ([Fig. 12](#) and [Fig. 13](#)). The industries' valuations have shrunk as well. The forward P/E for the Pharma industry stands at 14.6, down from 17.7 in March 2015, and the forward P/E in Biotech has fallen 6.1 percentage points since

March 2015 to 11.8 ([Fig. 14](#) and [Fig. 15](#)).

Why is the industry raising prices so dramatically? Perhaps it's because new drug approvals are down sharply. Only 22 new drugs cleared the FDA last year, the lowest number since 2010 and less than half the 45 approved in 2015, a 1/2 Reuters [article](#) reported. "The slowdown suggests the pharmaceuticals industry may be returning to more normal productivity levels after a spike in approvals in 2014 and 2015, when the haul of new drugs reaching the market hit a 19-year high," the article explained. Due to the dry spell, returns on R&D investment at pharma companies fell to 3.7% in 2016 from a high of 10.1% in 2010.

Ironically, this dry spell could bode well for small biotech companies if it reignites M&A. Transactions were in short supply last year. There were 326 deals in 2016, the lowest number in six years, a 1/3 Bloomberg [article](#) reported. Last year's deals were valued at about \$91 billion, down from \$118 billion the year prior. One deal in 2016--Shire's purchase of Baxalta--represented more than a third of the total.

"There's plenty of firepower to get deals done. The 14 biopharma firms with the most cash had more than \$220 billion in liquid assets on hand at the end of the third quarter and can raise plenty more in debt on top of that. Sluggish near-term sales growth adds to the motivation for many firms to act," the Bloomberg article stated. "More of that cash will likely be unlocked if and when the Trump administration makes it cheaper to repatriate cash held overseas. Johnson & Johnson, Amgen Inc., and Gilead Sciences Inc. have the most M&A-friendly combination of cash and back-of-the-pack sales growth. But there are many other contenders."

(2) *Distributing losses.* Health Care Distributors were the worst-performing industry within the S&P 500 Health Care sector last year, down 22.1%, but they've rebounded 10.9% since the presidential election ([Fig. 16](#)). Earnings have flat-lined over the past year, and analysts have scrambled to reduce their net earnings estimates ([Fig. 17](#) and [Fig. 18](#)). Not surprisingly, the industry's forward earnings multiple has fallen to 13.0, from a high of 19.6 in early 2015, leaving it closer to the bottom than the top of its 10-year P/E range of 10-20 ([Fig. 19](#)).

As branded and generic drug prices come under pressure, distributors get squeezed. An 10/31 *WSJ* [article](#) explains it well: "Cardinal and other distributors act as middlemen between drug makers and pharmacies. Their contracts with branded pharmaceutical companies often allow them to benefit from rising drug prices. As some branded drug makers rein in price increases, that benefit to distributors gets squeezed. ... Cardinal now expects generic drug prices to fall in the mid-to-high single digits in the current fiscal year, compared with its earlier expectation a mid-single digit decrease. It also expects branded drug manufacturer prices to increase 7% to 9% in the year, down from 10% previously." As a result, the company reduced its 2016 earnings estimate to between \$5.40 and \$5.60 per share, down from \$5.48-\$5.73.

(3) *Tech disappoints.* The S&P 500 Health Care Technology industry index is also in the sick bay after falling 21.3% last year and remaining under pressure since the election ([Fig. 20](#)). The industry has one stock, Cerner, which sells and services software and systems to hospitals, clinics, physician practices, labs, and pharmacies. The company, which acquired Siemens Health Services in 2015 for \$1.3 billion, missed analysts' forecasts in 2016, but is still growing quickly. A Cerner [press release](#) laid out a revenue growth target of roughly 11% in 2017 y/y and an earnings-per-share goal of \$2.50-\$2.70, with the midpoint equating to 13% y/y growth. At the time that the company gave its forecast, analysts were calling for \$2.69 a share in earnings. Earnings disappointments have taken a toll on the company's forward P/E, which has shrunk to a recent 18.5 from a high of 33.6 in January 2015 ([Fig. 21](#)).

## CALENDARS

**US. Thurs:** ADP Employment 172k, ISM NM-PMI 56.8, Jobless Claims 260k, Challenger Job-Cut Report, Weekly Consumer Comfort Index. **Fri:** Total & Private Nonfarm Payroll Employment 175k/165k, Unemployment Rate 4.7%, Average Hourly Earnings 0.3%, Average Workweek 34.4hrs, Merchandise Trade Balance -\$44.5b, Factory Orders -2.5%, Baker-Hughes Rig Count. (Bloomberg estimates)

**Global. Thurs:** UK Composite & NM-PMIs 55.0/54.7. **Fri:** Eurozone Retail Sales -0.4%*m/m*/1.9%*y/y*, Eurozone Economic Confidence 106.8, Germany Factory Orders -2.5%*m/m*/3.6%*y/y*, Germany Retail Sales -0.9%*m/m*/1.2%*y/y*, Canada Employment Change & Unemployment Rate -5k/6.9%. (DailyFX estimates)

## STRATEGY INDICATORS

**Stock Market Sentiment Indicators** ([link](#)): The Investors Intelligence Bull/Bear Ratio (BBR) climbed to 3.27 this week--the highest reading since June 2015. Bullish sentiment increased for the ninth week from 41.7% to 60.2%, the most bulls since July 2014. Bearish sentiment fell to 18.4% this week--representing the fewest bears since August 2015. The correction count edged up to 21.4% from 20.6%, which was the lowest since June 2014. The AAI Bull Ratio rose for the second week last week from 58.0% to 63.9% over the period. Bullish sentiment rose for the second time in three weeks, from 43.1% to 45.6%, while bearish sentiment fell from 32.3% to 25.7% the past two weeks.

**S&P 500 Earnings, Revenues & Valuation** ([link](#)): S&P 500 consensus forward revenues edged down last week from a record high, but forward earnings rose to a new record. The forward profit margin forecast was steady at a 15-month high of 11.7%, which is nearing the record high of 10.9% in September 2015 and up from its 24-month low of 10.4% in late March. Forward revenue growth for the S&P 500 was steady at 5.6%. That's the highest since May 2012 and up from a seven-month low of 2.7% in late February. Forward earnings growth was steady at 11.6%; that's the highest since October 2011 and compares to an 11-month low of 4.8% in late February. Valuation fell to 17.2 from a 22-month high of 17.3, which compares to February 2015's 12-year high of 17.4 and a 15-month low of 14.9 in January 2016. S&P 500 forward revenues and forward earnings are enjoying a tailwind now from easier *y/y* comparisons for Energy, but currency translation looks likely to remain a challenge. Looking at last week's results ex-Energy, the forward revenue and earnings growth rates fall to 3.9% and 8.2%, respectively. The ex-Energy forward profit margin improves to 11.3%, which is close to its record high of 11.5% in August 2007.

**S&P 500 Sectors Earnings, Revenues & Valuation** ([link](#)): Consensus forward revenue forecasts rose last week for 5/11 sectors, and forward earnings rose for 4/11. Energy and Real Estate were the only sectors to have both measures rise *w/w*. Forward revenues and earnings are at or around record highs for 5/11 sectors: Consumer Discretionary, Consumer Staples, Health Care, Industrials, and Tech. The forward P/S and P/E ratio rose for 10/11 sectors (all but Health Care). Excluding Real Estate, Financials' P/E has surged to a six-year high of 14.1 from 12.0 before the election, Health Care's P/E of 14.4 and P/S of 1.54 have been rising recently, but remain well below their 2015 highs of 17.9 and 1.88, respectively. With Energy's forward revenues and earnings improving, its valuation is beginning to come back to Earth; its P/S ratio of 1.46 compares to a record high of 1.56 in early May, and its P/E of 32.4 is down from a record high of 57.5 then. Higher *y/y* margins are expected for only 5/11 sectors in 2016, but is expected to improve for 9/11 sectors in 2017. Here's how they rank based on 2017 forecasts: Information Technology (to 20.1% in 2017 from 19.2% in 2016 and from 18.8% in 2015), Real Estate (16.5, 22.4, 21.2), Financials (15.7, 14.6, 14.8), Telecom (11.0, 10.8, 11.3), Health Care (10.8, 10.4, 10.4), Utilities (10.7, 11.0, 10.7), S&P 500 (10.7, 10.1, 10.2), Materials (10.3, 9.3, 9.3), Industrials (9.1, 8.8, 8.8), Consumer Discretionary (7.5, 7.2, 6.9), Consumer Staples (6.9, 6.6, 6.5), and

Energy (4.5, 1.3, 4.6).

## US ECONOMIC INDICATORS

**Motor Vehicle Sales** ([link](#)): Motor vehicle sales in December zoomed to a new record high. Total sales jumped from 17.9mu (saar) to 18.4mu last month--the highest reading since July 2005. For all of 2016, a record 17.6 million cars and light trucks were sold. Domestic light truck sales remain on a steep uptrend, climbing to a new cyclical high of 9.3mu (saar) last month. Import sales also surged to a new cyclical high, entirely driven by a big jump in light-truck sales. Domestic car sales continued to lack momentum: They did tick up to 5.3mu (saar) in December, but that reading wasn't far from August's cyclical low of 4.9mu, which was the weakest sales pace since May 2012.

## GLOBAL ECONOMIC INDICATORS

**Eurozone CPI Flash Estimate** ([link](#)): December's CPI rate is expected to be 1.1% y/y, according to the flash estimate--the highest since September 2013, though still well below the ECB's inflation target of just under 2.0. That would be the seventh straight reading above zero following sub-zero readings the prior four months. Of the main components, energy (to 2.5% from -1.1% y/y) is expected to have the highest annual rate in December--swinging from negative to positive--followed by services (1.2 from 1.1) and food, alcohol & tobacco (1.2 from 0.7); the yearly percent change in non-energy industrial goods prices is expected to be unchanged again at 0.3%.

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