



## MORNING BRIEFING

January 25, 2017

### Earnings World

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

(1) Pay no attention to the clowns behind the curtain. (2) From Ringling Brothers to Cirque du Trump. (3) S&P 500 revenues and earnings recovering to new record highs from Energy-led recession. (4) Q4 earning season likely to deliver 6% gain. (5) Analysts are raising their 2018 earnings estimates. (6) Energy, Financials, & IT showing best earnings revisions and forward earnings momentum. (7) Managing companies well despite Washington. (8) Some signs of life in overseas forward earnings. (9) Plenty of life in flash M-PMIs for US, Eurozone, and Japan.

**Earnings I: For Homebodies.** For a change, let's ignore Washington. Let's ignore the Republicans and the Democrats. Let's ignore the White House, Congress, and K Street. That's what the financial markets were doing for the past eight years. Investors were focusing most of the time on the Fed and the other central banks. Now we are all being forced to participate (in one way or the other, though mostly as observers) in the greatest circus of all times. I guess that is only fitting now that Ringling Brothers is going out of business. Instead it will be Cirque du Trump 24x7 for the next four years.

Of course, over the past eight years, stock market investors also have been focused on earnings, as they always are. While the 6.6% rally in the S&P 500 after Election Day through Tuesday's record high of 2280.07 might have had a lot to do with the results of that day, it helps that the earnings outlook has been improving. In our 8/22 [Morning Briefing](#), Joe and I declared that the earnings recession was over, and that it was mostly attributable to the S&P 500 Energy sector as a result of the plunge in oil prices from mid-2014 through early 2016.

Let's analyze earnings under America First (since that is the PC thing to do these days), then we can go global (at the risk of having to pay a border tax when we come back home). Consider the following:

(1) *Earnings.* On a year-over-year basis, S&P 500 operating earnings, based on Thomson Reuters (TR) data, showed declines from Q3-2015 through Q2-2016 ([Fig. 1](#)). It rose 4.1% during Q3-2016, and probably rose around 6.0% during Q4-2016.

Arguably, the earnings recession ended earlier than suggested by the growth rate based on the actual level of operating earnings (TR basis), which bottomed during Q1-2016, declining 11.7% from the previous record high during Q4-2014. It is up 15.8% from that recent bottom through Q3-2016 to a new record high ([Fig. 2](#)).

(2) *Revenues.* On a year-over-year basis, S&P 500 revenues declined from Q1-2015 through Q4-2015 ([Fig. 3](#)). It edged up during the first half of 2016, and was up 2.5% y/y during Q3-2016. This too suggests that the earnings recession actually ended in early 2016.

(3) *Q4 reporting season.* So far this earnings-reporting season, i.e., through the 1/19 week, the blended earnings number (including both reported and estimated figures) shows a gain of 4.7%, up from 4.1% the previous quarter. Joe and I are expecting the traditional upward "hook" in actual earnings relative to expected earnings for the current earnings season, which is why we predict that the actual growth rate will be close to 6.0%.

(4) *Forward ho!* S&P 500 forward operating earnings per share, which is the time-weighted average of consensus expected earnings for the current and next year, rose to \$133.65 during the 1/19 week ([Fig. 4](#)). That's a fresh record high and a good leading indicator for actual earnings as long as there is no recession coming over the next 12 months ([Fig. 5](#)).

The consensus estimate for 2018 has been moving higher in recent weeks, which doesn't usually happen, as optimistically biased analysts typically lower their distant forecasts as reality approaches. Analysts may be starting to incorporate tax cuts and less regulation into their 2018 estimates. They now expect that 2018 earnings will rise 12.0%, following this year's gain of 12.3%.

The analysts may also be raising their economic growth expectations, as evidenced by the firming in their 2017 and 2018 estimates for S&P 500 revenues, which are showing gains of 5.8% this year and 4.9% next year ([Fig. 6](#)). Forward revenues is also rising in record-high territory.

As Joe observed yesterday, the three forward earnings series for the S&P 500/400/600 continued to trend higher in record-high territory during the 1/19 week ([Fig. 7](#)).

(5) *Sectors leading and lagging.* The S&P 500 Net Earnings Revision Index (NERI) that Joe calculates turned much less negative over the past eight months through January ([Fig. 8](#)). While negative NERIs are the norm during recessions, NERIs also tend to be negative during maturing expansions, after they turn positive during the initial recovery periods. That reflects the optimistic bias of analysts during good times.

A glance at the S&P 500 sectors shows that most of the recent improvement has occurred in three sectors with positive NERIs, namely Energy, Financials, and Information Technology ([Fig. 9](#)). The following seven sectors remain in negative territory: Consumer Discretionary, Consumer Staples, Health Care, Industrials, Materials, Telecom Services, and Utilities.

An analysis of the sectors' forward earnings shows that over the past 6-12 months, the sectors with the best upward momentum are Energy, Financials, and Information Technology ([Fig. 10](#)). The others are mostly trending higher at a slow pace.

(6) *Going big.* Before Election Day, Joe and I predicted that S&P 500 earnings would be \$129.00 per share in 2017 and \$136.75 in 2018. After Election Day, on December 13, Joe and I [concluded](#) that there is a very good chance that the new Republican administration would succeed in lowering corporate tax rates and reducing costly government regulations on business given that the Republicans also won majorities in both houses of Congress. We assumed that this will happen this summer or fall and be retroactive to the beginning of this year. So we raised our earnings estimates to \$142.00 and \$150.00. We did get some pushback on timing, suggesting that the changes might not take effect until 2018. By the time we all know this, it won't matter much to the market, in our opinion. The important thing is that it happens.

Of course, the downside is that the new administration's trade policies might be too protectionist and bad for the economy. Trump is talking about a "border tax" rather than Paul Ryan's "border tax adjustment," which he said is too complicated. My hunch is that once the new administration renegotiates NAFTA, this issue will dissipate in importance. Then again, Trump did pull out of the TPP, which is widely viewed as consistent with his opposition to free trade treaties. Of course, he might renegotiate that one too. (Sorry that I violated my promise not to discuss Washington today, but it's hard to avoid doing so.)

**Earnings II: For Globalists.** Needless to say for the S&P 500 component companies, America First isn't their business model since they get roughly half their revenues from abroad. Nevertheless, they are mostly managed by experienced executives who have had to deal with Washington's latest hare-brained schemes for quite some time. Over the past eight years, they've had to contend with an onslaught of government regulations. Now with the new administration, they might get significant relief on this front, but face some new challenges over the protectionist inclinations of the Trump team.

My hunch is that this too shall pass. The administration's protectionism won't be as bad as feared, and US businesses will deal with the latest challenges thrown at them by Washington. Meanwhile, both the latest economic and earnings data suggest that the global economy is picking up:

(1) *Going global.* Given the "America First" mantra of the new Trump administration, Joe and I should be feeling quite comfortable with our long-held "Stay Home" investment recommendation. The alternative is to "Go Global." We keep getting cabin fever, and looking to go abroad for at least a short visit. After all, valuation multiples are lower overseas for the major MSCI stock market indexes: US (17.4), Japan (14.5), UK (14.5), EMU (14.2), and Emerging Markets (11.9) ([Fig. 11](#)).

Of course, when investing abroad, an investor has to get right both the stock index and the currency, or at least hedge against it. The ratio of the US MSCI to the All Country World ex-US MSCI remains on a strong upward trend that started in 2010 ([Fig. 12](#)). That's more the case when the latter is priced in dollars than in local currency.

(2) *Moving forward abroad.* Our Blue Angels analysis for the ACW ex-US MSCI shows that the index's forward earnings (in local currency) has been rising since the spring of 2016, though it remains in a flat range since 2011 ([Fig. 13](#)). The forward revenues picture for the index is also a bit brighter, but nowhere near record-setting levels as for US S&P 500 ([Fig. 14](#)).

(3) *Flash dancers.* Most encouraging for both the US and global economies is January's batch of flash M-PMIs, which Debbie discusses below ([Fig. 15](#)). The US index rose to 55.1, the highest since March 2015, and Japan's rose to 52.8, the highest since March 2014. The Eurozone's edged up to 55.1, the best level since April 2011, led by Germany's (56.5) and France's (53.4).

## CALENDARS

**US. Wed:** MBA Mortgage Applications, FHFA House Price Index, EIA Petroleum Status Report. **Thurs:** Leading Indicators 0.4%, Jobless Claims 246k, New Home Sales 595k, Advance Merchandise Trade Balance -\$65.5b, Kansas City Fed Manufacturing Index, Chicago Fed National Activity Index, NM-PMI Flash Estimate, Weekly Consumer Comfort Index, EIA Natural Report. (Bloomberg estimates)

**Global. Wed:** Germany Ifo Business Climate, Current Assessment, and Expectations Indexes 111.3/116.9/105.8. **Thurs:** UK GDP 0.5%q/q/2.1%y/y, Japan Headline, Core, and Core-Core CPI 0.2%/-0.3%/-0.1% y/y. (DailyFX estimates)

## STRATEGY INDICATORS

**S&P 500 Sectors Net Earnings Revisions** ([link](#)): The S&P 500's NERI weakened to -2.8% in January from -2.6% in December. That compares to a 25-month high of 0.7% in October and a seven-month low of -3.1% in November. NERI was positive for 3/11 sectors and improved m/m for six (versus three positive and six improving in December). Financials topped all sectors as it rose to a record high and Energy was the highest since June 2011. Two sectors were at multi-year lows: Health Care (lowest since February 2009) and Real Estate (lowest since May 2009). Energy has the longest positive NERI

streak of seven months, followed by Tech (6) and Financials (4). Real Estate is the worst, with 17 straight months of negative NERIs, followed by Utilities (14) and Telecom (9). Here are the sectors' January NERIs compared with their December results, ranked in descending order: Financials (15.7% in January [a record high since the data series started in 1995] from 12.6% in December), Energy (13.3 [67-month high], 6.3), Tech (4.3, 9.7), Utilities (-1.1 [14-month high], -1.2), S&P 500 (-2.8, -2.6), Materials (-5.7, -7.7), Industrials (-9.1, -13.3), Consumer Discretionary (-11.5, -10.5), Health Care (-12.6 [95-month low], -9.9), Consumer Staples (-16.1 [21-month low], -9.6), Telecom (-18.6, -20.8), and Real Estate (-17.0 [92-month low], -14.7).

**S&P 500 Earnings Season Monitor** ([link](#)): With over 13% of S&P 500 companies finished reporting Q4-2016 results, their revenue and earnings surprise metrics are weaker than at the comparable point of the Q3 season. On a mixed note, their y/y earnings growth comparisons are stronger, but y/y revenue growth has slowed. Of the 67 companies in the S&P 500 that have reported, 66% exceeded industry analysts' earnings estimates by an average of 3.9%; they have averaged a y/y earnings gain of 10.4%. At the same point in Q3-2016, a higher percentage of companies (83%) in the S&P 500 had beaten consensus earnings estimates by a larger 7.9% and earnings were up a smaller 4.9% y/y. On the revenue side, 45% beat sales estimates so far, coming in 0.2% below forecast and 2.3% higher than a year earlier. During Q3, a higher 70% were above forecast, which exceeded estimates by 1.2% and rose 4.4% y/y. Q4 earnings results are higher for 81% of companies versus 72% at the same point in Q3, and revenues are higher for 72% versus 72%. These figures will change markedly as more companies report Q4 results, but early data suggest Q2 was indeed the bottom for y/y earnings growth.

## US ECONOMIC INDICATORS

**Existing Home Sales** ([link](#)): Existing home sales--tabulated when a purchase contract closes--recorded the best year in a decade in 2016, though finished the year on a down note as affordability concerns and historically low supply levels pushed December sales lower. According to NAR's chief economist, "While a lack of listings and fast rising home prices was a headwind all year, the surge in rates since early November ultimately caught some prospective buyers off guard and dimmed their appetite or ability to buy a home as 2016 came to an end." December existing home sales sank 2.8% after a three-month gain of 6.6%. Single-family sales fell 1.8% to 4.88mu (saar) from December's cyclical high of 4.97mu; it was the first decline in four months. Volatile multi-family sales dropped 10.3% to 610,000 units (saar), following a 13.3% surge in November. The number of existing single-family homes on the market sank to 1.46mu last month (the lowest supply since December 1994) from 2016's peak rate of 1.89mu in May. Unsold inventory fell to 3.6 months' supply, the lowest since January 2005.

**Regional M-PMIs** ([link](#)): Three Fed districts so far have reported on manufacturing activity for January--New York, Philadelphia, and Richmond--and show growth accelerated for the third straight month. We average the composite, orders, and employment measures as data become available. The composite index (to 14.0 from 11.8) was in positive territory for the fifth month, climbing to its best reading since November 2014. It was driven by both the Philadelphia (23.6 from 19.7) and Richmond (12 from 8) measures, which were the strongest since fall 2014; New York's (6.5 from 7.6) slipped a bit from December's eight-month high. The new orders index (14.7 from 12.1) showed activity grew for the fourth month--reaching a 28-month high--as the Philadelphia (26.0 from 14.9) and Richmond (15 from 11) measures were the best since November 2014 and March 2016, respectively. Orders in New York (3.1 from 10.4) slowed from December's 27-month high. The employment gauge (6.4 from -3.2) was in positive territory for the first time in six months--at its highest reading since June 2014. Factories in Philadelphia (12.8 from 3.6) and Richmond (8 from -1) hired workers at the fastest rates in 21 and 10 months, respectively; New York's employment measure (-1.7 from -12.2) showed continued job cuts, but at a slower pace.

**US M-PMI Flash Estimate** ([link](#)): US manufacturing activity in January accelerated for the fourth straight month, at its fastest pace in 22 months, signaling a marked upturn in the health of the sector. Markit's M-PMI flash estimate continued to rebound from September's three-month low of 51.5 to 55.1 this month. According to the report, the solid improvement in business conditions was primarily driven by sharper increases in output and new orders, which performed at the best rates in 22 and 28 months, respectively. At the same time, companies hiked their purchasing activity at the fastest pace since early 2015 and expanded payrolls further in order to meet growing demand. Looking ahead, firms were generally optimistic about the next 12 months, posting the highest reading since last March.

## GLOBAL ECONOMIC INDICATORS

**Eurozone PMI Flash Estimates** ([link](#)): Activity in the Eurozone continued to expand at a robust pace during the first month of the new year, according to the flash estimate, with manufacturing growth the best since April 2011. The Composite Output Index edged down to 54.3 in January, barley budging from December's 54.4--which was the highest since May 2011. The M-PMI (to 55.1 from 54.9) climbed to a 69-month high, while the NM-PMI (53.6 from 53.7) held near recent highs. The start of 2017 enjoyed the best employment gains in nine years, as hiring accelerated in both the manufacturing and services sectors--driven by sustained growth in new orders. January's flash results included a new index on business expectations for the next 12 months; it was the highest since data were first collected in July 2012, with elevated optimism in both the manufacturing and services sectors. By country, Germany's Composite Output Index (54.7 from 55.2) showed a slowing in growth this month, though it remained above the Eurozone average; France's (53.8 from 53.1) held below the Eurozone average, but accelerated at its fastest pace since June 2011. Elsewhere in the Eurozone, business activity growth slowed though remained solid and among the best seen over the past year.

**Japan M-PMI Flash Estimate** ([link](#)): Japan's manufacturing sector grew this month at its sharpest rate in nearly three years, according to the flash estimate. The M-PMI continued to improve since bottoming at 47.7 last May, climbing to 52.8 at the start of this year--the highest reading since March 2014. Both production and new orders expanded at a robust pace, though the former was slightly slower than at the end of last year. The acceleration in new orders was driven in part by a sharp increase in foreign demand, as new export orders rose at the fastest pace in over a year. The newly launched business expectations index hit a 44-month high this month.

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