



MORNING BRIEFING

January 31, 2017

Devilish Details

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

(1) Politics is a blood sport. (2) Aneurin Bevan and Ivanka Trump say so. (3) The cradle of civilization is no longer so civilized. (4) Mexico is Trump's piñata. (5) Noise-to-signal ratio rising. (6) Bond Vigilantes Model says bond yield should be 3.50%, not 2.50%. (7) Despite upturn, bond yields remain near zero in Germany and Japan. (8) Record highs for S&P 500 forward revenues and earnings, as well as for our Boom Bust Barometer and Weekly Leading Index. (9) Spirited animals.

Strategy: Blood Sport. The son of a coal miner, Aneurin Bevan was a Welsh Labour Party politician who was the Minister for Health in the British government from 1945 to 1951. While he remains one of Wales's most revered politicians, he is best known for observing: "Politics is a blood sport." Less well known, but just as relevant to our politics today, is: "We know what happens to people who stay in the middle of the road. They get run down." Here is another relevant gem: "I read the newspapers avidly. It is my one form of continuous fiction."

Bevan's insight was confirmed by Ivanka Trump in a 10/13 [interview](#) in which she too observed that politics is "vicious" and "a blood sport." She should know now that she is exposed to it as one of her father's closest advisers. President Donald Trump has virtually guaranteed that the next four years will be vicious by threatening to overthrow both the ruling class in the US and the post-WW II world order. He made that clear during the campaign, and doubled down in his [Inaugural Address](#) with the following explicit threat:

"For too long, a small group in our nation's Capital has reaped the rewards of government while the people have borne the cost. Washington flourished--but the people did not share in its wealth. Politicians prospered--but the jobs left, and the factories closed. The establishment protected itself, but not the citizens of our country. Their victories have not been your victories; their triumphs have not been your triumphs; and while they celebrated in our nation's capital, there was little to celebrate for struggling families all across our land. That all changes--starting right here, and right now, because this moment is your moment: it belongs to you."

The political establishment must have been cringing hearing those words, and some of them are bound to be committed to stopping Trump, especially his Democratic opponents. Don't forget that the first item in Trump's "Contract with the American Voter" is to "propose a constitutional amendment to impose term limits on all members of Congress." When asked about this proposal, Senator Mitch McConnell (R-KY), the majority leader, said "I would say we have term limits now. They're called elections. And it will not be on the agenda in the Senate."

During his first week in office, Trump didn't open up that can of worms, but he certainly moved fast on imposing a four-month hold on allowing refugees into the United States and temporarily barring travelers from seven Muslim-majority countries: Iran, Iraq, Libya, Somalia, Sudan, Syria, and Yemen. They are in, or close by, Mesopotamia, the cradle of civilization. Trump thinks they aren't so civilized anymore. In addition, he seemed to upend talks with Mexico over trade and immigration issues, treating the country like his personal piñata.

After hitting a record high on Wednesday, the S&P 500 slipped 0.2% on Thursday and Friday and fell again yesterday, by 0.6% ([Fig. 1](#)). Leading the decline on Monday were the S&P 500 Energy, Materials, and Technology sectors, with drops of 1.8%, 1.0%, and 0.8% ([Fig. 2](#) and [Table 1](#)). The US tech industry relies on foreign engineers and other technical experts for a sizeable percentage of its workforce. Google, Apple, and other tech giants expressed dismay over Trump's executive order on immigration. "I share your concerns" about Trump's immigration order, Apple CEO Tim Cook wrote in a memo to employees. "It is not a policy we support," he added. This might be a bit of an over-reaction given that the seven countries aren't known as cradles for tech-savvy experts, with the exception of Iran perhaps.

The ascendance of Trump certainly has upset the status quo and increased uncertainty. Yet the stock market has ascended impressively since Election Day, as investors seemed to focus mostly on his plans to cut personal and corporate taxes and reduce regulations. Yesterday, he followed up with an executive order aimed at cutting back on government regulations. However, the market now may be starting to focus more on his "America First" trade and immigration policies.

It's clear that for every action by the Trump administration, there is likely to be a very hostile reaction from his opponents. For them, the Devil is literally in every policy detail coming out of the White House. Politics is certainly likely to be very much a blood sport for the next four years. For investors, this will create lots of noise. The question is, will they be able to focus on the signal, i.e., on the important developments for earnings and valuation? We will do our best to do so despite all the demonizing that seems to have poisoned our body politic.

Bonds: The Vigilantes Model. Our "Bond Vigilantes Model" simply compares the bond yield to the growth rate in nominal GDP on a y/y basis ([Fig. 3](#)). This model shows that since 1953, the yield has fluctuated around the growth of GDP. Both series tend to be volatile. As a result, they rarely coincide. When they diverge for a while, the model forces us to explain why this is happening and can reveal important inflection points in the relationship.

Nominal GDP rose 3.5% during Q4-2016. That's 100bps above the 10-year Treasury bond yield, which jumped 62 bps to 2.50% since Election Day. The spread between the bond yield and the growth rate in nominal GDP has been negative since Q2-2010 ([Fig. 4](#)). Why isn't the yield closer to 3.50% or even higher given that Trump's policies are expected to boost growth and inflation?

There have been plenty of divergences between the yield and the economic growth rate in the past. From the 1950s to the 1970s, the spread between the bond yield and nominal GDP growth was mostly negative. Investors underestimated the growth of nominal GDP because they underestimated inflation. Bond yields rose during this period, but remained consistently below nominal GDP growth. That changed during the 1980s when investors belatedly turned much warier of inflation, just as it was heading downwards. As a result, the yield tended to trade above the growth in nominal GDP during that decade.

The 7/27/83 issue of my weekly commentary was titled, "Bond Investors Are the Economy's Bond Vigilantes." I concluded: "So if the fiscal and monetary authorities won't regulate the economy, the bond investors will. The economy will be run by vigilantes in the credit markets." During the 1980s and 1990s, there were several episodes when rising bond yields slowed the economy, which allowed bond yields to fall again. As the yield cycled in this vigilant fashion, the trend was down as falling inflation weighed on nominal GDP growth. Since the mid-1990s, the Bond Vigilantes seemed less active. As inflation fell, the spread between the bond yield and nominal GDP growth narrowed and fluctuated around zero.

The current divergence may reflect skepticism about Trump's stimulus plans. They might get bogged down in the legislative process. They might not be enacted. They might not work even if implemented.

Another more plausible explanation is that the bond market has become increasingly globalized in recent years. While government bond yields have also risen in both Germany and Japan in recent weeks, levels in both remain near zero, with the former at 0.46% and the latter at 0.08% ([Fig. 5](#) and [Fig. 6](#)). Both the ECB and BOJ are likely to keep their official rates near zero.

On the other hand, the Fed is widely expected to continue hiking the federal funds rate ([Fig. 7](#)). We are expecting two rate hikes by the Fed this year. The unemployment rate has been just below 5.0% for the past eight months through December. The PCE inflation rate remains below 2.0%, but not far below. In December, the headline rate was 1.6% y/y, while the core rate was 1.7% y/y ([Fig. 8](#)). Debbie and I are still predicting that the 10-year US Treasury yield will range between 2.00%-2.50% during the first half of this year and between 2.50%-3.00% during the second half of this year.

Earnings: Record Highs. As Joe reports below, the forward earnings of the S&P 500/400/600 all rose to record highs last week ([Fig. 9](#)). S&P 500 forward revenues is also at a record high ([Fig. 10](#)). Industry analysts may be starting to drink Trump's Kool-Aid. We see that in their 2017 and 2018 earnings estimates, which aren't doing what they typically do--namely, get cut by the analysts ([Fig. 11](#)). As a result, industry analysts are currently estimating that S&P 500/400/600 earnings will be up 12.1%, 12.5%, and 15.1% this year and 12.0%, 12.5%, and 17.4% next year.

Also at record highs are our Boom Bust Barometer (BBB) and our YRI Weekly Leading Indicator (YRI-WLI), as Debbie discusses below. The BBB is the four-week average of the CRB raw industrials spot price index (on a weekly average basis) divided by weekly initial unemployment claims ([Fig. 12](#)). It is highly correlated with S&P 500 forward earnings.

The YRI-WLI is the average of the Consumer Comfort Index (which is a four-week average) and the four-week average of Boom-Bust Barometer ([Fig. 13](#)). It is highly correlated with the S&P 500. Animal spirits are thriving, according to our record-setting indicators. It's nice to see that the economy can rise above the blood sports played by our politicians.

CALENDARS

US. Tues: Consumer Confidence Index 112.2, Employment Cost Index 0.6%, Chicago PMI 55.2, S&P Case-Shiller PMI, FOMC Begins. **Wed:** ADP Employment 168k, Motor Vehicle Sales 17.7mu, Construction Spending 0.2%, MBA Mortgage Applications, ISM M-PMI 55.0, EIA Petroleum Status, FOMC Meeting Announcement. (Bloomberg estimates)

Global. Tues: Eurozone GDP 0.4%q/q;1.7%y/y, Eurozone Headline & Core CPI 1.5%/0.9% y/y, Germany Unemployment Change & Unemployment rate -5k/6.0%, Germany Retail Sales 0.6%^m/0.5%^y, France GDP 0.4%q/q/1.1%y/y, Canada GDP 1.4%y/y, China M-PMI 51.2, Japan M-PMI, BOJ Long- and Short-Term Policy Rates, BOJ Monetary Policy Statement & Outlook Report. **Wed:** Eurozone, Germany, France, and Italy M-PMIs 55.1/56.5/53.4/53.3, UK M-PMI 55.9. (DailyFX estimates)

STRATEGY INDICATORS

YRI Weekly Leading Index ([link](#)): Our Weekly Leading Index (WLI)--a good coincident indicator that can confirm or raise doubts about stock market swings--rose for the fifth week during the week of

January 21 to another new record high, up 0.7% w/w and 4.8% over the period. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). Our BBB climbed 1.2% and 8.7% over the comparable periods, also to a new record high. Jobless claims fell for the fifth week to 245,500 (4-wa), the lowest reading since November 1973. The CRB raw industrials spot price index--another BBB component--moved higher during the week; meanwhile, the WCCI was unchanged after falling 3.2% the prior three weeks.

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings rose for all three indexes to record highs last week. SmallCap was at a record high for the first time in four weeks. The yearly change in forward earnings is up from six-year lows in early 2016 for all three indexes and also rose w/w as y/y comparisons have eased. In the latest week, LargeCap's forward earnings surged to a 27-month high of 7.5% y/y from 6.4%, which compares to a six-year low of -1.8% in October 2015; MidCap's jumped to a 24-month high of 7.1% from 6.2%, which compares to a six-year low of -1.3% in December 2015; and SmallCap's rose to a 27-month high of 10.2% from 10.1%, which compares to a six-year low of 0.3% in December 2015. Growth rates now expected for 2016 and 2017: LargeCap 0.8% and 12.1%, MidCap 1.9% and 12.5%, and SmallCap 6.5% and 15.1%.

S&P 500/400/600 Forward Valuation ([link](#)): Valuations rose last week, but most remain slightly below recent multi-year highs. LargeCap's forward P/E rose to 17.1 from 17.0, which matches its 22-month high of 17.1 in early December. That's up from a 15-month low of 14.9 in January 2016, but remains slightly below the 11-year high P/E of 17.2 in February 2015 (when Energy sector earnings were depressed) and well below the record high of 25.7 in July 1999. MidCap's forward P/E improved to 18.8 from 18.6; that's below early December's 15-year high of 19.2 and compares to a three-year low of 15.0 in January 2016 and a record high of 20.6 in January 2002. SmallCap's rose to 19.7 from 19.5; that's up from a three-year low of 15.5 in February 2016, and compares to a 15-year high of 20.5 in early December and record high of 20.9 in April 2002.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): Q1 earnings estimate revision activity picked up last week for the S&P 500 sectors as more companies reported Q4 earnings. The Q1 consensus fell w/w for nine of the 11 S&P 500 sectors and rose for two. Energy rose 4.4% for the week, followed by a 1.7% gain for Consumer Discretionary. Sectors with the biggest w/w declines in their Q1 forecasts: Industrials (-5.4%), Materials (-1.7), Telecom (-1.3), and Real Estate (-0.9). The S&P 500's Q1-2017 EPS forecast fell 13 cents w/w to \$30.41, but is down only 0.6% from \$30.53 at the end of Q4. That represents a forecasted pro forma earnings gain of 13.0% y/y, the strongest growth since Q3-2011, with the forecast down from 13.6% a week earlier and 13.8% at the end of Q4. Since the end of Q4, Q1 estimates are higher for 2/11 sectors and lower for 9/11. The Q1 forecast for Consumer Discretionary has risen 1.5%, while Energy's has gained 1.2%. Industrials is down the most (-5.4), followed by Materials (-1.7), Telecom (-1.3), and Real Estate (-0.9). The S&P 500's Q1-2017 forecasted earnings gain of 13.0% y/y would be its third straight gain after four declines and compares to Q4-2016's blended 7.0%, Q3-2016's 4.3%, Q2-2016's -2.1%, Q1-2016's -5.0%, Q4-2015's -2.9%, Q3-2015's -0.8%, Q2-2015's 1.3%, and Q1-2015's 2.2%. Four of the 11 sectors are expected to beat the S&P 500's y/y earnings gain of 12.9% in Q1-2017, with analysts expecting Energy to report a profit relative to a year-ago loss and thinking Industrials and Telecom will record y/y earnings declines. That's an improvement from the 7/11 sectors rising in Q4-2016, and compares to 9/11 rising in Q3 and 6/10 rising during the quarters from Q4-2015 to Q2-2016. The latest forecasted Q1-2017 earnings growth rates vs. their blended Q4-2016 growth rates: Energy (returning to a profit in Q1 from a year-ago loss vs. -5.1% in Q4), Materials (19.1% vs. 7.6%), Tech (16.6, 8.7), Financials (16.0, 19.2), S&P 500 (13.0, 7.0), Consumer Staples (6.6, 6.3), Health Care (5.2, 5.8), Consumer Discretionary (3.9, 1.0), Real Estate (3.2, -0.4), Utilities (1.5, 7.2), Telecom (-1.7, -2.4), and Industrials (-2.6, -0.7).

S&P 500 Earnings Season Monitor ([link](#)): With 32% 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 160 companies in the S&P 500 that have reported, 68% exceeded industry analysts' earnings estimates by an average of 3.3%; they have averaged a y/y earnings gain of 9.8%. At the same point in Q3-2016, a higher percentage of companies (78%) in the S&P 500 had beaten consensus earnings estimates by a larger 7.1% and earnings were up a smaller 4.3% y/y. On the revenue side, 52% beat sales estimates so far, coming in 0.5% above forecast and 3.2% higher than a year earlier. During Q3, a higher 63% were above forecast, which exceeded estimates by 0.7% and rose 2.7% y/y. Q4 earnings results are higher for 76% of companies versus 69% at the same point in Q3, and revenues are higher for 72% versus 72%. These figures will continue to change markedly as more companies report Q4 results, but early data suggest Q2-2016 was indeed the bottom for y/y earnings growth.

US ECONOMIC INDICATORS

Personal Income & Consumption ([link](#)): Real consumer spending climbed to a new record high in December, growing at its fastest pace in three months. Spending ended the year on an up note, increasing 0.3%--after gains of 0.2% and 0.1% the previous two months--led by a 1.4% jump in real durable goods consumption and a 0.3% gain in services. Last quarter, real personal consumption expenditures expanded 2.5% (saar), slowing from Q3's pace; however, goods consumption accelerated 5.2% (saar) from 3.5% during Q3 as growth in durable goods spending (to 10.9% from 11.6%) remained in double digits and nondurable goods consumption (2.3 from -0.5) swung from negative to positive. While income growth has slowed in recent months, solid gains in employment, along with rising wages and lower taxes, should support robust spending this year.

New Home Sales ([link](#)): New home sales in December sank 10.4% to a 10-month low of 536,000 units (saar) after a three-month advance of 7.0%, slipping just below year-ago levels. Sales had reached a cyclical high of 622,000 units in July. (These sales are tabulated when contracts are signed, making it a timelier barometer of the residential market than existing home sales.) Sales for all of 2016 reached 561,000 units, up 12.2% from 2015 and the best year since 2007. At the end of 2016, there were 259,000 new single-family homes on the market, the most since August 2009, though less than half its peak during the housing boom. The months' supply of homes climbed to 5.8, above July's 17-month low of 4.6 months. January's survey of the National Association of Homebuilders (NAHB) showed builders' optimism remained very high, with foot traffic the best in a decade.

Pending Home Sales ([link](#)): December's Pending Home Sales Index--measuring sales contracts for existing-home purchases--advanced 1.6% to 109.0 last month, virtually even with last December's reading. NAR's chief economist, Lawrence Yun, noted that pending sales rebounded in December as enough buyers fended off rising mortgage rates and alarmingly low inventory levels to sign a contract. Regionally, pending home sales in the West (5.0% y/y) and the South (0.5) were above year-ago levels, while they were below in the Midwest (-3.4) and the Northeast (-1.2). According to Yun, "The main storyline in the early months of 2017 will be if supply can meaningfully increase to keep price growth at a moderate enough level for households to absorb higher borrowing costs. Sales will struggle to build on last year's strong pace if inventory conditions don't improve." Currently, the small number of listings in the affordable price range is squeezing prospective first-time buyers.

Regional M-PMIs ([link](#)): Five Fed districts have reported on manufacturing activity for January--New York, Philadelphia, Richmond, Kansas City, and Dallas--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 12.6 from 11.8) was in positive territory for the fifth month, climbing to its best reading since September 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; Kansas City's (9) was unchanged at December's cyclical high, while Dallas' (11.9 from 14.8) and New York's (6.5 from 7.6) showed slightly slower growth than December's. The new orders index (16.0 from 10.3) showed activity grew for the fifth month--reaching a 70-month high. Kansas City's (20 from 5) gauge was the highest since March 2011, while Philadelphia's (26.0 from 14.9), Dallas' (15.7 from 10.1), and Richmond's (15 from 11) were the best since November 2014, April 2014, and March 2016, respectively. Orders in New York (3.1 from 10.4) slowed from December's 27-month high. The employment index (6.2 from -1.0) was in positive territory for the first time in 19 months--at its highest reading since the end of 2014. Factories in Philadelphia (12.8 from 3.6), Dallas (6.1 from -3.4), and Richmond (8 from -1) hired workers at the fastest rates in 21, 14, and 10 months, respectively, while Kansas City's (6 from 8) showed a slight slowing from December's 29-month high. New York's employment measure (-1.7 from -12.2) showed continued job cuts, but at a slower pace.

GLOBAL ECONOMIC INDICATORS

Eurozone Economic Sentiment Indicators ([link](#)): The Economic Sentiment Index (ESI) for January increased slightly in the Eurozone (+0.4 points to 108.2), and remained broadly stable in the EU (-0.2 points to 108.7) as a whole, after both posted impressive gains of 1.3 and 1.8 points, respectively, in December to new cyclical highs. This month, ESIs rose notably in Spain (+1.4 to 107.4), Italy (+1.3 to 105.6), and the Netherlands (+1.3 to 108.4); they eased in France (-0.6 to 104.9) and Germany (-0.3 to 109.1). At the sector level, industry (+0.8 to 0.8) and services (+0.4 to 13.5) confidence each reached new cyclical highs this month, while consumer (+0.4 to -4.7) sentiment was just shy of a new cyclical high. Meanwhile, retail trade (-1.1 to 2.4) and construction (-0.7 to -12.8) confidence fell during the month, the latter after reaching a cyclical high in December.

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