



MORNING BRIEFING

February 2, 2017

Panning for Gold

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

(1) Looking for good buys. (2) Looking for earnings outperformers. (3) A simple screen. (4) Industrials benefitting from end of energy recession. (5) Railroads hauling more fracking sand, again, and even coal. (6) Lots of Financials making the grade. (7) Some Tech industries stand out. (8) Specialty Chemicals are special. (9) Surprising finds among consumer-related industries. (10) Mexicans who lose their factory jobs will be shovel-ready. (11) We reckon there are only 900,000 jobs to bring back from Mexico.

Sectors: On the Prowl. With S&P 500 forward earnings hitting a record high last week, Jackie and I thought it an opportune time to dive deep into the data with Joe in search of industries that are expected to produce strong earnings growth this year and next.

Here's how we winnowed the 100-plus S&P 500 industries we track down to 14. First, we looked for industries that analysts expect will have 2017 earnings growth that's at least four percentage points better than it was in 2016. In addition, we looked for those with earnings growth estimates for 2018 that are nearly as strong or stronger than the growth expected this year. And finally, we only included industries where analysts have been raising their forward earnings estimates over the past 13 weeks. It's important to note that valuation wasn't a factor that we used to sift through the industries, though we discuss it below.

Who made the cut? Not surprisingly, S&P 500 Financials were well represented, with Asset Management, Diversified Banks, and Regional Banks appearing on our list. Industrials had a strong showing as well, with Agricultural & Farm Machinery, Airlines, Railroads, and Industrial Machinery jumping over our hurdles. A few industries in the Technology and Consumer Discretionary sectors make an appearance. Perhaps the most surprising members of our list are Soft Drinks and Hypermarkets & Super Centers. They may not be growing earnings as quickly as some other industries, but results are expected to improve nicely from 2016 through 2018. Read on for more details:

(1) *Industrials dominate.* The end of the recession in the oil patch and hopes for increased infrastructure spending under President Trump have propelled earnings estimates higher for a number of industries in the Industrials sector. S&P 500 Railroads, for one, has returned to the fast track. As fracking activity picks up, so does the need to transport sand, pipes, and equipment for new wells ([Fig. 1](#)). Likewise, the low price of natural gas prompted utilities to use natural gas instead of coal, which is typically transported on the rails ([Fig. 2](#)). However, with frackers emerging from hibernation and coal usage appearing to bottom, Railroad earnings have begun to grow once again.

"Higher energy prices, favorable agricultural markets and improving business and consumer confidence all support a return to positive volume growth this year," said Union Pacific's CEO Lance Fritz, according to a 1/19 [WSJ article](#).

The Railroads industry is expected to grow earnings by 10.5% this year and 11.4% next year after earnings contracted by 4.5% in 2016 ([Fig. 3](#)). The earnings estimate for this year has increased by

2.8% over the past 13 weeks. Revenue growth, which had been falling since hitting a peak in 2010, is expected to be 4.4% this year and 4.7% in 2018 ([Fig. 4](#)). Some of that strong growth is already reflected in the Railroads industry's 12-month forward P/E of 18.1, which is up from a low of 12.4 in January 2016 ([Fig. 5](#)).

Analysts also have high hopes for the S&P 500 Industrial Machinery industry. It too will be helped by the rebound in the oil patch and President Trump's campaign promise to repair the nation's infrastructure. Analysts expect 8.5% earnings growth this year and an even faster 11.2% gain next year after the industry produced no earnings growth in 2016 ([Fig. 6](#)). The industry's revenue growth is expected to move from a 3.7% decline last year to positive growth of 3.6% this year and 3.8% next year ([Fig. 7](#)).

Like Railroads, the forward P/E for Industrial Machinery has risen to a lofty 19.1 as of January 19 ([Fig. 8](#)). A number of times in the past, however, a high P/E has occurred when earnings were depressed and the industry went on to rally as earnings improved. The S&P 500 Industrial Machinery stock index basically has moved sideways since 2014, and began to rally only in recent months, ignited by the Trump presidency ([Fig. 9](#)). Forward earnings estimates for this industry over the past 13 weeks have improved by 1.7%.

Also making our elite list are the S&P 500 Airlines and the S&P 500 Agricultural & Farm Machinery industries. Airlines earnings are expected to decline 13.8% in 2016, and decline again by 8.6% this year before growing by 15.0% in 2018 ([Fig. 10](#)). The pattern is similar in Ag & Farm Machinery, where a 16.6% decline in earnings last year is expected to be followed by a 6.6% decline this year and a 16.7% jump in earnings next year ([Fig. 11](#)). Forward earnings estimates for Agricultural & Farm Machinery have improved by 22.0% over the past 13 weeks, along with a forward P/E that has jumped to 22.5.

(2) *Financials*. We've been optimistic about the prospects for the S&P 500 Financials sector, and analysts' earnings estimates for this year and next continue to support that stance. Lower loan losses and litigation expenses combined with a pickup in loan activity and fixed-income trading have gone a long way toward repairing some of the damage done by the housing recession that haunted the industry for much of the past 10 years.

If the yield curve steepens some more, with the difference between the two-year and 10-year Treasury notes returning to more normal levels, then earnings could really improve. If President Trump liberalizes some of the regulations in the sector, all the better. Analysts may be anticipating some of this potential improvement, as they have revised their forward earnings estimates for both Regional and Diversified Banks by 7.0% each over the last 13 weeks.

The S&P 500 Regional Banks industry is expected to grow earnings by 10.3% this year and 13.2% in 2018 ([Fig. 12](#)). Revenue, which grew 6.3% last year, is thought to grow 6.1% in 2017 and 5.3% in 2018 ([Fig. 13](#)).

S&P 500 Diversified Banks also is in recovery mode, with earnings expected to climb from a 0.2% drop in 2016 to an 8.0% gain this year and a 14.2% increase in 2018 ([Fig. 14](#)). The industry's forward P/E of 12.6 remains reasonable both relative to the industry's history and relative to the market currently ([Fig. 15](#)).

The S&P 500 Asset Management & Custody Banks industry also earned a place on our list, with earnings growth improving from 0.3% last year to 11.5% growth in 2017 and 11.3% growth in 2018 ([Fig. 16](#)). Revenue also has gone from declines last year to 4.5% and 4.7% growth expected this year and next ([Fig. 17](#)).

(3) *Technology*. The S&P 500 Technology Hardware, Storage & Peripheral and Electronic Equipment & Instruments industries are the only two Tech-sector industries that meet our criteria. While they may not have the barn-burning earnings growth of some other Tech industries this year, they are expected to see y/y earnings growth accelerate in 2018, unlike many other faster-growing Tech industries.

The 600-pound gorilla in the S&P 500 Technology Hardware, Storage & Peripherals industry is Apple. On Tuesday, the company reported 3% sales growth to a record \$78.4 billion thanks to a 5% increase in iPhone shipments in the December quarter. However, gross margins narrowed, and profit in the quarter fell 2.6% to \$17.9 billion, or \$3.38 a share. Since the result was six cents better than analysts expected, the shares rallied on the news, a 2/1 *WSJ* [article](#) reported.

Earnings for the Technology Hardware, Storage & Peripherals industry fell by 10.6% last year, but is expected to grow 8.6% this year and 11.6% in 2018 ([Fig. 18](#)). Analysts have increased forward earnings estimates for the industry by 4.4% over the last 13 weeks. Revenue growth follows a similar pattern, with an 8.7% decline in 2016, followed by an estimated 4.0% gain this year and 4.3% increase next year ([Fig. 19](#)). The industry's forward P/E of 12.4 is off its lows, but still below the highs of the last decade ([Fig. 20](#)).

(4) *Odds 'n Ends*. S&P 500 Specialty Chemicals is the only industry in the Materials sector to make the grade, with earnings improving from 2.2% growth last year to 10.5% growth in 2017 and 10.2% growth in 2018 ([Fig. 21](#)). The industry includes stocks exposed to growing areas. Sherwin-Williams sells paints to consumers sprucing up their homes and is in the midst of acquiring Valspar. It recently reported earnings that beat estimates, according to a 1/26 *WSJ* [article](#). PPG Industries--which makes coatings, specialty materials, and glass--counts the automotive industry as a big customer. Albemarle develops and manufactures lithium compounds used in lithium batteries, car tires, plastic bottles, and other markets. The industry's forward P/E, at 19.8, is roughly between its highs and lows over the past 15 years ([Fig. 22](#)).

A handful of consumer-related names made the cut: S&P 500 Footwear, Apparel Retail, Soft Drinks, and Hypermarkets & Super Centers all have earnings growth that's accelerating. Footwear--with its one constituent, Nike--is expected to post the fastest earnings growth of this group: 8.2% forecasted for 2016, 12.8% in 2017, and 15.3% next year. Apparel Retail's slow growth of 2.1% last year is expected to pick up to 7.9% this year and 9.9% next year. The industry benefits from having discount retailer TJX as a member, as it's one of the few retailers that's successfully competing against Amazon. Earnings in the Soft Drinks industry are expected to rise from a meager 1% last year to 6.0% this year and a respectable 8.1% in 2018. Likewise, Super Centers' growth is slow but moving the right direction: -4.2% in 2016, 3.0% this year, and 6.5% in 2018.

It appears that there aren't many bargains left in this bull market. There certainly were some before Election Day, but there seem to be fewer now. On the other hand, if Trump's policies, on balance, boost economic growth and earnings, then there is more upside for lots of stocks. For now, we are focusing on the industries where analysts' outlook for earnings is particularly upbeat. They should outperform whether Trump succeeds or disappoints.

Mexico: Shovel-Ready. President Trump is going to do what he said he would do on the campaign trail. On January 25, he signed an executive order for Congress to prioritize building the US-Mexican border wall. To pay for it, he proposed imposing an import tax on Mexican goods, though he seems to be looking for an alternative that won't pick the pocket of American consumers. Trump also intends to renegotiate NAFTA to bring manufacturing jobs back home to the US. Melissa and I have been looking for data to show how many such jobs might be brought back. We've also tried to assess the scale of

the illegal Mexican immigration issue, which is clouded by alternative facts. Consider the following:

(1) *Factory workers in Mexico*. [Data](#) from the Mexican government's National Institute of Statistics and Geography show that the total number of Mexicans employed in the country's own manufacturing sectors was 3.6 million during November 2016, or 16.5% of the Mexican labor force. That's not as many jobs, or as big of a percentage, as one would have assumed. The number of manufacturing jobs in the US stood at 12.3 million during December. Even if Trump brings back 25% of the factory jobs in Mexico, that's only 900,000 of them. Might all those displaced Mexicans then head for the border wall with shovels?

(2) *Illegal Mexicans in the US*. Mexicans made up 52% of unauthorized US immigrants in 2014, according to Pew. But Pew also [reports](#) that only 5% of the US labor force was composed of unauthorized immigrants during that year.

Recent studies show conflicting data regarding the flow of Mexican migration to the US. According to a Pew [study](#) published in November 2015, there was a net outflow of Mexican immigrants (both authorized and unauthorized) of 140,000 from 2009 to 2014, by the research organization's own measure. A senior Pew demographer dismissed more recent Current Population Survey data for 2015 as an anomaly, inconsistent "with anything else we've seen," according a 11/7 [article](#) in the *Independent*. In a [report](#) based on that "questionable" data for 2015, the Centre for Immigration Studies (CIS) observed that there was a surge in Mexican immigrants of 740,000 during 2015 over 2014.

Apparently, fewer of the illegal immigrants coming in from Mexico are actually Mexicans. The U.S. Customs and Border Protection [website](#) of the Department of Homeland Security reports:

"In Fiscal Year 2016, total apprehensions by the Border Patrol on our southwest border, between ports of entry, numbered 408,870. This represents an increase over FY15, but was lower than FY14 and FY13, and a fraction of the number of apprehensions routinely observed from the 1980s through 2008. Apprehensions are an indicator of total attempts to cross the border illegally. Meanwhile, the demographics of illegal migration on our southern border has changed significantly over the last 15 years--far fewer Mexicans and single adults are attempting to cross the border without authorization, but more families and unaccompanied children are fleeing poverty and violence in Central America. In 2014, Central Americans apprehended on the southern border outnumbered Mexicans for the first time. In 2016, it happened again."

The CIS report cited above came to an interesting and highly relevant conclusion: "In the last two years, the growth in the immigrant population has been largely driven by immigrants from Mexico and the rest of Latin America. This suggests that illegal immigration has increased in recent years ... However, it must be remembered that legal immigrants significantly outnumber illegal immigrants. Of the more than 42 million immigrants living in the country in the second quarter of 2015, roughly three-quarters are in the country legally. While the impact of illegal immigration is often the subject of intense national debate, the much larger flow of legal immigrants has seen almost no discussion, even though its impact on American society is much larger."

This is a good point. Legal immigration has always been a source of economic vitality and growth for the US. Illegal immigration is more about social issues, including crime, than economic ones. We all know that there are lots of illegal workers doing jobs that Americans don't want. Perhaps a program providing temporary work permits needs to be considered, with a path toward citizenship in exchange for hard work. In my opinion, the brouhaha over immigration will be resolved in a way that reduces the illegal variety, while maintaining the legal influx that has always made America great.

CALENDARS

US. Thurs: Jobless Claims 253k, Productivity & Unit Labor Costs 1.2%/1.8%, Weekly Consumer Comfort Index, Challenger Job-Cut Report. **Fri:** Total & Private Nonfarm Payroll Employment 175k/170k, Unemployment Rate 4.7%, Average Hourly Earnings 0.3%, Average Workweek 34.4hrs, ISM NM-PMI 57.0, Factory Orders 0.9%, Baker-Hughes Rig Count. (Bloomberg estimates)

Global. Thurs: Japan Consumer Confidence, BOE Rate Decision 0.25%, BOE Asset Purchase Target 435b, BOE Inflation Report, ECB Publishes Economic Bulletin, BOJ December Minutes, Draghi, Carney. **Fri:** Eurozone Retail Sales 0.3%/m/m/1.8%/y/y, Eurozone, Germany, France, and Italy Composite PMIs 54.3/54.7/53.8/53.0, Eurozone, Germany, France, and Italy NM-PMIs 53.6/53.2/53.9/52.6, UK Composite & NM-PMIs 56.0/55.8. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators ([link](#)): The Investors Intelligence Bull/Bear Ratio (BBR) climbed from 3.33 to 3.51 this week--highest reading since early May 2015. It's the eighth straight week above 3.00. Bullish sentiment rebounded to a 19-month high of 61.8% after pulling back to 58.2% last week. Bearish sentiment was 17.6%, little changed for the second week from the 17.3% reading two weeks ago--which was the fewest bears since July 2015. The correction count retreated from 24.3% to 20.6%, back at its reading five weeks ago, which was the lowest since June 2014. The AAll Bull Ratio fell for the third week last week to 48.5% after climbing the prior three weeks from 58.0% to 64.7%. Bullish sentiment fell from 46.2% to 31.6% over the three-week span, while bearish sentiment rose from 25.2% to 33.5% over the period.

S&P 500 Earnings, Revenues & Valuation ([link](#)): S&P 500 consensus forward earnings rose to a record high last week, and forward revenues edged up to less than 0.1% below its early January record. The forward profit margin forecast remained steady at a 16-month high of 10.8%, 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 improved to 5.8% from 5.7%. That matches mid-December's 5.8%, which was the highest since May 2012 and up from a seven-month low of 2.7% in late February 2016. Forward earnings growth dropped to 11.4% from 11.7%; that was the highest since October 2011 and compares to an 11-month low of 4.8% in February 2016. Valuation rose to 17.4 from 17.2, matching February 2015's 12-year high of 17.4, and compares to 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 and improving prospects for Financials, 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 8.0%, respectively. The ex-Energy forward profit margin improves to 11.4%, 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, Information Technology, and Real Estate were the only sectors to have forward revenues and earnings 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. Energy's forward revenues and earnings are at or near 15-month highs. The forward P/S ratio rose for 6/11 sectors, and P/Es rose for 5/11. Excluding Real Estate, Financials' P/E of 14.0 is up from 12.0 before the election and remains near mid-December's six-year high of 14.2. Health Care's P/E of 14.5 and P/S of 1.55 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 1.44 compares to a record high of 1.56 in early May, and its P/E of 30.5 is down from a record high of 57.5 then. Higher y/y

margins were expected for only 7/11 sectors in 2016, but are expected to improve for 9/11 sectors in 2017. Here's how they rank based on 2017 forecasts: Information Technology (to 20.2% in 2017 from 19.4% in 2016 and from 18.7% in 2015), Real Estate (16.5, 23.0, 21.2), Financials (15.9, 14.8, 14.8), Telecom (10.9, 10.8, 11.3), Health Care (10.7, 10.4, 10.4), Utilities (10.7, 11.0, 10.7), S&P 500 (10.7, 10.2, 10.2), Materials (10.3, 9.5, 9.4), Industrials (9.1, 8.9, 8.8), Consumer Discretionary (7.5, 7.2, 6.9), Consumer Staples (6.9, 6.6, 6.5), and Energy (4.6, 1.1, 4.5).

US ECONOMIC INDICATORS

Construction Spending ([link](#)): After hitting its best level since April 2006 in November, construction spending unexpectedly retreated in December as public construction spending sank 1.7% on widespread weakness. Total spending dipped 0.2% after advancing six of the prior seven months by a total of 3.7%. Private construction spending rose for the seventh time in eight months, to a new cyclical high, up 0.2% m/m and 5.0% over the period. Residential investment advanced for the third straight month, up 0.5% in December and 3.5% over the time span, while nonresidential investment was flat after increasing six of the prior seven months by 5.1%. Within residential investment, single-family construction rose for the third month by a total of 5.8% to a new cyclical high, while multi-family investment advanced for the sixth time in seven months by 6.6% to a new record high. Home-improvement spending dropped 0.6% after a two-month gain of 0.7%. Within nonresidential investment, spending on office, educational, amusement & recreation, and commercial structures remained on steep uptrends, while lodging remained stalled around recent highs.

Motor Vehicle Sales ([link](#)): Motor vehicle sales slipped in January after zooming to a new cyclical high in December. Total sales fell to 17.6mu (saar) from 18.4mu at the end of last year, which was the best sales pace since July 2005. January's setback reflects a drop in domestic car sales from 5.3mu to a five-year low of 4.7mu (saar). Domestic light truck sales (9.2mu, saar) were little changed from December's cyclical high of 9.3mu, while import sales (3.7) held near their cyclical high of 3.9mu recorded in December.

ADP Employment ([link](#)): Private industries added 246,000 to January payrolls, considerably above the average monthly gain of 179,000 during the final half of last year. December's (to 151,000,000 from 153,000) gain was little changed from the initial estimate, while November's (226,000 from 215,000) was higher. January's advance was driven by a 201,000 increase in service-providing jobs; goods-producing companies added 46,000 jobs, a two-year high. Within service-providing, trade, professional & business services (71,000) hired the most workers, followed by trade, transportation & utilities (63,000) and health care & social assistance (49,000). Medium-sized companies were at the top of the leader board for the second month, adding 102,000 jobs--81,000 service-providing and 21,000 goods-producing. Large companies (83,000) once again held the number-two spot, led by service-providing (71,000) jobs; goods-producing (12,000) companies added to payrolls for the first time in three months. Small businesses (62,000) provided the fewest jobs, with service-providing (50,000) accounting for 80% of January's increase; goods-providing (12,000) companies added jobs after cutting every month of last quarter.

GLOBAL ECONOMIC INDICATORS

Global Manufacturing PMIs ([link](#)): Global manufacturing activity in January matched December's pace, which was the best in 34 months. The JP Morgan M-PMI was unchanged at 52.7 last month--the highest since February 2014--after climbing steadily from August's 50.8. New orders (53.9 from 53.7), new export orders (52.3 from 51.4), and input prices (61.9 from 61.0) all accelerated during the month, while global output (to 53.9 from 53.7) slowed slightly and employment (51.4) matched December's rate. Among the larger industrial nations for which data are available, faster rates of growth were

recorded in the Eurozone (55.2, 69-month high), US (55.0, 22-month high), and Japan (52.7, 34-month high), while the UK's (55.9) was little changed from December's 30-month high of 56.1. Within the Eurozone, Austria (57.3, 70-month high) posted the fastest growth, followed by the Netherlands (56.5), Germany (56.4, 36-month high), Spain (55.6, 20-month high), Ireland (55.5), France (53.6, 68-month high), and Italy (53.0), while Greece (46.6) contracted at the fastest pace in 16 months. The only other countries to record declines last month were South Korea (49.0), Brazil (44.0), and Turkey (48.7). The launch of a new index tracking business sentiment was at a 19-month high at the start of 2017, with improvements seen in the US, Eurozone, UK, Japan, India, Brazil, and Russia.

US Manufacturing PMIs ([link](#)): Manufacturing activity in January grew at its fastest pace in 26 months according to the ISM survey, and the best in 22 months according to Markit's. ISM's M-PMI increased for the fifth month from 49.4 in August to 56.0 last month, the highest since November 2014. The new orders (to 60.4 from 60.3) component edged further above 60, while the production (61.4 to 59.4) gauge was above 60 for the first time since November 2014. Both are the highest readings since fall 2014. The employment index was in expansionary territory for the fourth month, climbing to a 29-month high of 56.1 last month; it contracted for eight of the first nine months of last year. The remaining two components that compose the M-PMI show supplier deliveries (53.6 from 53.0) slightly faster, while inventories (48.5 from 47.0) contracted at a slower pace. Markit's M-PMI (55.0 from 54.3) rose to its highest reading since March 2015. According to the report, all five components contributed to January's gain, led by the sharpest expansion of incoming new work in over two years, while inventories accumulated at a rate not seen in nearly a decade as firms responded to stronger demand. Output expanded at the strongest pace in 22 months. Input prices continued to accelerate according to both surveys, with ISM's the highest since May 2011 and Markit's the sharpest in almost two and a half years.

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