



MORNING BRIEFING

February 28, 2017

Buffett's Rules & Ratios

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

(1) On the cheap side. (2) Buffett betting on and against Trump. (3) The Oracle sees diluted tax reform and no BAT. (4) The President's speech. (5) Guns and butter? (6) Buffett Ratio suggests stocks aren't so cheap. (7) Forward P/E and P/S ratios are also awfully high, unless Trump delivers earnings-boosting corporate tax cuts. (8) A protectionist-triggered recession is possible, but not likely. (9) More likely is that the economy will run very hot, or not so hot. (10) Dallas Fed survey shows regional energy recession is over. (11) Animal spirits roaming throughout the land.

Strategy I: Buffett's Bet. In a CNBC [interview](#) yesterday, Warren Buffett, the Oracle of Omaha, declared that stocks are "on the cheap side." He has played the Trump rally by putting another \$20 billion into the stock market since Election Day. Stocks are cheap, he said, because interest rates remain very low. This suggests that Buffett is betting both on and against Trump. He obviously made a very good decision not to let his personal politics get in the way of joining the animal spirits rally since Election Day. Warren Buffett is a long-time Democrat who supported Hillary Clinton, but he says he agrees with President Donald Trump on some issues—including homeland security as a top priority, boosting economic growth, and increasing the incomes of more Americans who have been hurt by globalization.

Yet, Buffett seems to be betting that interest rates won't go up much anytime soon. In other words, he isn't convinced that Trump will succeed in stimulating the economy very much with fiscal policy. He said that Republican leaders will probably have to scale back their tax reform ambitions because their current plan is too complicated to pass Congress, especially if they intend to do something on this by August: "I think complexity will give way to speed." He expressed skepticism that the Republican tax plan will be revenue-neutral "without the craziest dynamic scoring in the world." He also said that he doubts that the border adjustment tax (BAT) will see the light of day.

On Friday, the White House denied a report that President Trump's economic adviser Gary Cohn told CEOs that morning that the administration opposes the BAT plan. On Thursday, Trump told Reuters that he supports "some sort" of border tax. Before he took office, Trump panned the idea of a border tax, saying it would be too "complicated" and push up the dollar. Perhaps he will clarify his opinion on the matter in tonight's speech.

Over the weekend, Treasury Secretary Steven Mnuchin said Trump will discuss his tax-reform plan in the speech tonight before Congress. However, the President's upcoming budget won't include cuts to such entitlement programs as Social Security and Medicare. "We are not touching those now," Mnuchin told Fox News' *Sunday Morning Futures with Maria Bartiromo*. "So don't expect to see that as part of this budget."

Melissa and I agree with Buffett on the revenue-neutrality issue. The plan that the administration is outlining suggests a guns-and-butter fiscal approach with more defense spending, no cuts in entitlements, and lower tax rates. It's hard to see how this won't lead to higher bond yields, especially if

the Fed starts increasing the federal funds rate at a pace closer to normal. (We are still forecasting that the US Treasury 10-year bond yield will range between 2.00%-2.50% during the first half of this year and 2.50%-3.00% during the second half of this year.)

In his interview, Buffett told CNBC on Monday that mixing politics and investment strategies would be a “big mistake.” He added, “Probably half the time [in] my adult life, I’ve had a president other than the one I voted for, but that’s never taken me out of stocks.” That’s been our pitch for a while: Investors should focus on whether the political environment is on balance bullish or bearish, not on whether the policies are right or wrong.

Strategy II: Buffett’s Valuation Ratio. The Oracle of Omaha is credited with having devised the Buffett Ratio to measure stock market valuation. This indicator takes the market capitalization of all stocks traded in the US and divides it by GDP. In an [interview](#) he did with *Fortune* in December 2001, Buffett said, “For me, the message of that chart is this: If the percentage relationship falls to the 70% or 80% area, buying stocks is likely to work very well for you. If the ratio approaches 200%—as it did in 1999 and a part of 2000—you are playing with fire.”

Yet, Buffett thinks that stocks are cheap even though his ratio has risen from a cyclical low of 1.51 during Q3-2015 to 1.59 during Q3-2016 ([Fig. 1](#)). So it is approaching the cyclical high of 1.69 during Q1-2015 and the record high of 1.80 during Q1-2000. That’s using the Fed’s quarterly data on the total market capitalization of US equities excluding foreign issues. Now consider the following related indicators:

(1) *S&P 500 Buffett Ratio.* A similar ratio using the market cap of the S&P 500 to the revenues of this composite is highly correlated with the Buffett Ratio ([Fig. 2](#)). It was 1.82 during Q4-2016, nearing the record high of 2.01 during Q4-1999.

(2) *Forward ratios.* It turns out that the S&P 500 version of the Buffett Ratio is highly correlated with the S&P 500’s price-to-sales (P/S) ratio using forward revenues as the denominator ([Fig. 3](#)). On a monthly basis, it rose to 1.91 during February, suggesting that the Buffett Ratio is already back to its previous record high, just before the Tech bubble burst.

Joe and I also monitor the forward P/S ratio on a weekly basis ([Fig. 4](#)). It rose to a record high of 1.91 during the week of February 16. It is highly correlated with the S&P 500’s forward P/E, which rose to 17.8 during the same week.

Strategy III: Two Scenarios. There are two alternative economic scenarios that follow from the above discussion. The economy continues to grow in both, though running hotter in one than the other. Of course, there is a third scenario in which the economy falls into a recession. That’s possible if Trump’s protectionist leanings trump his pro-growth agenda. However, we believe that Trump is intent on maintaining free trade, but on a more bilateral basis than a multilateral basis. Then again, in an interview Sunday with NBC’s *Meet the Press*, Trump threatened to drop out of the World Trade Organization if it interferes with his plans to penalize companies that move American production offshore.

Last Thursday, Treasury Secretary Steven Mnuchin played good cop to Trump’s bad cop on our trade issues with China. He said that the Trump administration will stick to existing processes on judging whether China manipulates its currency to gain unfair trade advantages. By those criteria, however, China does not match the US definition of a currency manipulator. “We have a process within Treasury where we go through and look at currency manipulation across the board,” Mnuchin said in a CNBC [interview](#). “And we’ll go through that process,” he said. “We’ll do that as we have in the past, and we’re

not making any judgments until we continue that process.” So here are the two growth scenarios in brief:

(1) *Very hot*. If Trump delivers a guns-and-butter fiscal program—including most of the tax cuts he has promised along with more defense spending and public/private-financed infrastructure spending—economic growth could accelerate. But so might inflation, given that the economy is at full employment. Government deficits would probably remain large or widen, causing public debt to increase. In this scenario, the Fed would be emboldened to increase interest rates in a more normal fashion rather than gradually. Bond yields would rise. This should be a bullish scenario, on balance, if the boost to earnings from lower corporate tax rates and regulatory costs is as big as promised.

(2) *Not so hot*. Alternatively, if Buffett is right, and interest rates stay at current low levels, that would imply that Trump’s grand plans for the economy won’t be so grand after all in their implementation. Animal spirits would evaporate. Interest rates would stay low, but valuations would be hard to justify if earnings don’t get the boost that was widely discounted after Election Day.

Let’s hope secular stagnation doesn’t make a comeback. We are rooting for animal spirits. They are certainly alive and well in the Fed’s district surveys of regional business activity during February. Last week, Debbie and I reviewed the strong results for New York, Philadelphia, and Kansas City. Yesterday, the Dallas survey—that covers Texas, northern Louisiana, and Southern New Mexico—showed a spectacular rebound from the region’s oil industry recession ([Fig. 5](#)). The current general business index rose to 24.5 this month, the highest since April 2006. That’s after being below zero from January 2015 through September 2016.

The averages of the four regional composite business indicators rose to 25.1 this month, the highest since December 2004 ([Fig. 6](#)). The comparable new orders index rose to 22.3, the highest since June 2006, while the employment index rose to 9.9, the highest since November 2014.

CALENDARS

US. Tues: Real GDP & Price Deflator 2.1%/2.1%, Consumer Confidence Index 111.0, Advanced Merchandise Trade Balance-\$66.0b, Richmond Fed Manufacturing Index, Chicago PMI 52.9, S&P Case Shiller Home Price Index 0.7%/m/m/5.4%/y/y. **Wed:** Personal Income & Consumption 0.3%/0.3%, Headline & Core PCED 0.4%/0.3%, Motor Vehicle Sales 17.7mu, Construction Spending 0.5%, ISM M-PMI 56.1, MBA Mortgage Applications, EIA Petroleum Status Report, Beige Book, Kaplan. (Bloomberg estimates)

Global. Tues: France GDP 0.4%q/q/1.1%y.y, Australia GDP 0.7%q/q/1.9%y/y, China Official & Caixin/Markit M-PMI 51.2/50.2, Japan Housing Starts 916k. **Wed:** Eurozone, Germany, France, and Italy M-PMIs 55.5/57.0/52.3/53.5, Germany CPI 0.6%/m/m/2.1%/y/y, Germany Unemployment Change & Unemployment Rate -10k/5.9%, UK M-PMI 55.7, BOC Rate Decision 0.50%. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings rose last week for LargeCap and was at a record high again for MidCap. LargeCap’s is 0.1% below its late January record high, and SmallCap’s was down for a second straight week to 0.2% below its early February record. The yearly change in forward earnings is up from six-year lows in early 2016 for all three indexes as y/y comparisons have eased. In the latest week, LargeCap’s forward earnings rose to a 28-month high of 7.9% y/y from 7.6%, which compares to a six-year low of -1.8% in October 2015; MidCap’s jumped to a 25-month high of 9.3% from 8.8%, which compares to a six-year low of -1.3% in December 2015; and SmallCap’s rose to

a 31-month high of 12.5% from 11.9%, which compares to a six-year low of 0.3% in December 2015. Growth rates now expected for 2017 and 2018 before the impact of tax rate changes: LargeCap 10.9% and 12.0%, MidCap 11.1% and 12.9%, and SmallCap 13.6% and 17.7%.

S&P 500/400/600 Forward Valuation ([link](#)): Valuations stayed relatively steady last week, most at multi-year highs. P/Es have been melting up recently and beginning to reflect the impact of lower tax rates on corporate earnings, but the 'E' still remains low as analysts await legislative changes to the tax rate. LargeCap's forward P/E rose to a 13-year high of 17.7 from 17.6. That's up from a 15-month low of 14.9 in January 2016 and the post-Lehman-meltdown P/E of 9.3 in October 2008, but remains well below the record high of 25.7 in July 1999. MidCap's forward P/E was steady at a 15-year high of 19.2; that compares to a three-year low of 15.0 in January 2016 and a record high of 20.6 in January 2002. SmallCap's was unchanged at 19.9; that's up from a three-year low of 15.5 in February 2016, and compares to a record high of 20.9 in April 2002 and a 15-year high of 20.5 in early December when Energy's earnings were depressed. Looking at their forward price/sales ratios since data became available in 2004, valuations are similarly elevated for the three indexes: LargeCap's P/S of 1.93 and MidCap's 1.37 are at record highs, while SmallCap's 1.06 is down from 1.15 in July 2015 and a record high of 1.17 in November 2013.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): Q1 earnings estimate revision activity slowed last week for the S&P 500 sectors as retailers reported Q4 earnings. The Q1 consensus rose w/w for four of the 11 S&P 500 sectors, was steady for one, and fell for six. Q1 forecasts rose w/w for Real Estate (5.5%), Energy (1.9), Utilities (0.3), and Tech (0.3). Sectors with the biggest w/w percentage declines in their Q1 forecasts: Materials (-0.9), Consumer Staples (-0.7), and Consumer Discretionary (-0.4). The S&P 500's Q1-2017 EPS forecast fell 3 cents w/w to \$29.70, and is down 2.9% from \$30.53 at the end of Q4. That represents a forecasted pro forma earnings gain of 10.5% y/y, the strongest growth since Q3-2011, with the forecast down from 10.7% 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 10/11. The Q1 forecast for Energy is unchanged, followed by a slight decreases for Financials (-0.5) and Consumer Discretionary (-0.6). Industrials is down the most (-6.4), followed by Materials (-5.1), Consumer Staples (-2.5), and Health Care (-2.0). The S&P 500's Q1-2017 forecasted earnings gain of 10.5% y/y would be its third straight gain after four declines and the highest since Q3-2011. All 11 sectors are expected to record positive y/y earnings growth in Q1-2017, and four are expected to beat the S&P 500's y/y earnings gain of 10.5%. Analysts expect Energy to report a profit relative to a year-ago loss and no longer think Industrials and Telecom will record y/y earnings declines as they had expected four weeks ago. That's an improvement from the 8/11 sectors rising y/y 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. -0.9% in Q4), Financials (15.5% vs. 11.6%), Tech (13.2, 12.2), Materials (12.1, 7.0), S&P 500 (10.5, 7.7), Consumer Staples (3.8, 7.1), Industrials (4.0, -0.9), Health Care (3.4, 7.1), Telecom (2.4, -1.5), Real Estate (1.4, 9.4), Utilities (0.7, 9.5), and Consumer Discretionary (0.5, 4.7).

S&P 500 Earnings Season Monitor ([link](#)): With nearly 92% of S&P 500 companies finished reporting Q4-2016 results, their revenue and earnings surprise metrics are mostly weaker than at the comparable point of the Q3 season. On a positive note, their y/y revenue and earnings growth comparisons are the highest since Q3-2014. Of the 459 companies in the S&P 500 that have reported, 68% exceeded industry analysts' earnings estimates by an average of 3.7%; they have averaged a y/y earnings gain of 9.8%. At the same point in Q3-2016, a higher percentage of companies (72%) in the S&P 500 had beaten consensus earnings estimates by a larger 6.2%, and earnings were up a lower 4.1% y/y. On the revenue side, 50% beat sales estimates so far, coming in 0.1% above forecast and 4.0% higher than a year earlier. During Q3, a higher 54% of companies beat forecasts and results beat by a slightly higher 0.2%, but revenues rose a lower 2.7% y/y. Q4 earnings results are higher y/y for 69% of companies

versus 70% at the same point in Q3, and revenues are higher for 71% versus 67%. These figures will change marginally as the remaining 41 companies report Q4 results, but the results to date suggest that Q1-2016 was the bottom for y/y revenue growth and that Q2-2016 was the earnings growth bottom.

US ECONOMIC INDICATORS

Durable Goods Orders & Shipments ([link](#)): Capital spending and orders took a step back in January after a strong finish to 2016. Nondefense capital goods shipments ex aircraft (used in calculating GDP) slipped 0.6% last month after rising four of the last five months of 2016 by 2.6%. The comparable orders measure (a proxy for future business investment) fell 0.4% after rising six of the last seven months of last year by 4.3%. These core shipments expanded 6.0% (saar) during the three months ending January, based on the three-month average, the strongest growth rate since October 2014. Real core orders increased 8.6% (saar) over the comparable period, the best since September 2014. Headline durable goods orders rebounded 1.8% in January following a two-month decline of 5.6% as orders for nondefense and defense aircraft & parts rose 69.9% and 59.9%, respectively. Excluding transportation, orders (-0.2%) fell for the first time in seven months, after climbing 4.4% during the final half of last year.

Regional M-PMIs ([link](#)): Four Fed districts have now reported on manufacturing activity for February—New York, Philadelphia, Kansas City, and Dallas—and show a big pickup in economic activity. We average the composite, orders, and employment measures as data become available. The composite index (to 25.1 from 15.3) was in positive territory for the sixth straight month at its highest reading since December 2004. Philadelphia (43.3 from 23.6) and New York (18.7 from 6.2) gauges improved dramatically, while gains for Kansas City (14.0 from 9.0) and Dallas (24.5 from 22.1) were more modest. The new orders index (22.3 from 16.2) accelerated for the seventh consecutive month, reaching its fastest pace since June 2006. The Philadelphia (38.0 from 26.0), New York (13.5 from 3.1), and Kansas City (26.0 from 20.0) measures showed faster growth in orders, while Dallas' (11.6 from 15.7) showed slower, though still robust, billings. The employment index (9.9 from 5.8) was positive for the second month after negative readings the prior 18 months. Kansas City's (17.0 from 6.0) gauge showed the strongest job growth in the region's manufacturing sector since March 2011, while Dallas' (9.6 from 6.1) was the best since the end of 2015; Philly's (11.1 from 12.8) slowed slightly. Manufacturers in New York (2.0 from -1.7) added to payrolls for the first time since last May.

Pending Home Sales ([link](#)): Insufficient supply in the Midwest and West in January drove the Pending Home Sales Index—measuring sales contracts for existing-home purchases—to its lowest reading in a year, at 106.4. Regionally, pending home sales were mixed, falling in the West (-9.8%) and Midwest (-5.0) and rising in the Northeast (2.3) and South (0.4); year-ago comparisons show the same mix, with the Northeast (3.6% y/y) and South (2.0) in the black and the Midwest (-3.8) and West (-0.4) in the red. NAR's chief economist, Lawrence Yun, noted that sales got off to a fantastic start last month, but January's retreat in contract signings suggest that "activity will likely be choppy in coming months as buyers compete for the meager number of listings in their price range."

GLOBAL ECONOMIC INDICATORS

Eurozone Economic Sentiment Indicators ([link](#)): The Economic Sentiment Index (ESI) for February edged higher in both the Eurozone (+0.1 points to 108.0) and the EU (+0.3 points to 108.9), with the former reaching a new cyclical high and the latter just shy of December's cyclical high of 109.0. This month, ESIs rose notably in Spain (+1.3 to 108.7) and France (+1.1 to 106.1) and slightly in Italy (+0.2 to 105.6) and the Netherlands (+0.1 to 108.5); Germany's (-0.8 to 108.3) fell for the second month. At the sector level, construction (+2.6 to -10.3), services (+1.0 to 13.8), and industry (+0.5 to 1.3)

confidence all reached new cyclical highs this month, while consumer (-1.4 to -6.2) and retail trade (-0.4 to 1.9) sentiment fell during the month, the latter for the second time since reaching a cyclical high in December.

Eurozone Money Supply ([link](#)): M3 growth, which the ECB regards as a barometer of future inflation, was 4.9% y/y in January, near its recent low of 4.5% recorded in October. The growth rate for M1 increased 8.4% y/y, down from July 2015's peak rate of 11.6%. At 4.7% y/y, M2's rate was little changed from October's 19-month low of 4.6%. Country data, which lag the overall Eurozone data, show M3 growth is the weakest in the Netherlands (1.6 y/y) and Greece (2.7). For the top four Eurozone economies, the M3 growth rates for Germany (5.7) and Spain (4.9) are down from recent highs, while France's (6.0) is the highest since May 2011. Italy's (3.1) remains in a volatile flat trend. Portugal's rate (9.0) continues to trend higher, while Ireland's (6.9) is down from August's peak rate of 15.3%. (Note: The latest M3 data are available through January for Italy and the Netherlands, through December for all the rest.)

Eurozone Credit ([link](#)): Credit demand in the Eurozone is expanding at a slower pace. We track private-sector lending by monetary financial institutions (MFIs), which shows that the three-month annualized change in total lending advanced €144 billion in the three months ended January, down from €398 billion in November, which was the strongest since February 2011. Comparable data for borrowing by households (to €138 billion from €165 billion) and nonfinancial corporations (€40 billion from €100 billion) showed slowing demand from November to January. Lending among financial institutions (-€34 billion) contracted in the three months through January, its first negative reading since summer 2014.

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