



MORNING BRIEFING

March 15, 2017

Animal Spirits Showing Up in Earnings

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

(1) Happy eighth birthday. Now take a nap. (2) Trump wins whether ACA-R&R passes or fails. (3) The swamp thickens. (4) Breitbart wants to sink Ryan. (5) Small business owners think now is a good time to expand. (6) Old problems for SBOs were regulations and taxes. New one is shortage of workers. (7) Boom-Bust Barometer still boomerily bullish for earnings and stocks. (8) Forward revenues and earnings at record highs. (9) It's not all about Trump: Global economy seems to be improving.

Strategy: Draining the Swamp. Joe and I are hoping that the stock market bull will celebrate his eighth anniversary by taking a rest. As you get older, it's not healthy to be sprinting. It makes more sense to jog at a leisurely pace. Taking regular naps is also widely recommended by health professionals for older folks. Presumably that advice applies to all aging animals.

The bull obviously got recharged by the animal spirits unleashed following Election Day. Undoubtedly, investors got into the spirit as well on expectations that Trump's Electoral College win along with the Republican majorities in both houses of Congress would allow the new administration to charge ahead with its program, particularly deregulation and tax reform. So far so good on the former, but the latter is on hold while Washington focuses on Affordable Care Act repeal and replace (ACA-R&R). Trump has declared that he intends to drain the swamp. Doing so is already proving to be hard and tedious work. The bull may also find it hard to charge ahead in the swamp water.

Melissa is our resident Washington watcher. Her theory is that Trump doesn't care if the GOP's healthcare bill doesn't pass through Congress. If R&R fails to happen soon, he won't press the issue. He'll let it go and move on to tax reform under a 2018 budget resolution, which is being worked on behind the scenes as ACA-R&R takes center stage and flounders. Trump will be happy to let Obamacare implode on its own. Politically, Trump still can say he made ACA-R&R his first priority to protect healthcare for Americans, as he promised during the campaign. He can later also say "I told you so" to Congress once Obamacare totally implodes. "It could self-repeal in this scenario," says Melissa. "Then Congress will have no choice but to replace it."

Melissa's theory is backed up by a 3/9 CNN [report](#): "In an Oval Office meeting featuring leaders of conservative groups that already lining up against House Republicans' plan to repeal and replace Obamacare, President Donald Trump revealed his plan in the event the GOP effort doesn't succeed: Allow Obamacare to fail and let Democrats take the blame, sources at the gathering told CNN." Sources said that Trump strongly expressed that now is the chance for repeal and replace.

Trump's secret ploy has been hidden in plain sight. In his 2/24 Conservative Political Action Committee [speech](#), he stated: "[F]rom a purely political standpoint, the single best thing we can do is nothing. Let it implode completely, it's already imploding. You see the carriers are all leaving. I mean, it's a disaster. But two years, don't do anything. The Democrats will come to us and beg for help, they'll beg and it's their problem. But it's not the right thing to do for the American people, it's not the right thing to do." So either Trump will get a plan that might work, or he'll get zippo and let the Dems take the fall if Obamacare continues to implode.

Trump must know—because the stock market has been telling him so—that his big win would be tax reform. Market commentators have been baffled as to why the administration has put ACA-R&R ahead of tax reform. The answer is to get ACA-R&R out of the way whether it passes or not. Either way, we expect tax reform to remain on the timeline that officials have been signaling, which is to finalize writing it over the summer.

CNN also [reported](#) that on Monday, Breitbart News escalated its battle against House Speaker Paul Ryan by publishing audio of Ryan saying in October that he is “not going to defend Donald Trump—not now, not in the future.” The website, which was previously run by current White House strategist Steve Bannon, has blasted the House GOP’s plan as “House Speaker Paul Ryan’s Obamacare 2.0 plan.” Bannon certainly won’t shed a tear if Ryan sinks in the swamp along with the current ACA-R&R bill.

The good news is that while the bull may be forced to nap on high ground surrounded by the swamp as Trump tries to drain it, the economy and earnings may continue to thrive on animal spirits. In the next section, let’s examine the latest survey of small business owners. Then let’s see if animal spirits are having any impact on earnings.

US Economy: Small Business Owners Remain Upbeat. Of all the so-called “soft data” showing the surge in animal spirits following Election Day, the survey of small business owners (SBOs) conducted by the National Federation of Independent Business (NFIB) certainly stands out. That matters a great deal for the economy, since SBOs account for lots of employment and business spending, as we have previously shown on numerous occasions. If they are happy, that augurs well for the economy.

As Debbie discusses below, the NFIB survey’s optimism index jumped from 94.9 during October to 105.9 during January, and edged down to 105.3 last month ([Fig. 1](#)). The past two months are the best readings since December 2004. There was a dip in the percentage of SBOs saying that the number one problem they face is government regulation to 18.2%, the lowest since November 2011 ([Fig. 2](#)). Taxes remain their number-one problem, with 21.0% saying so last month, but that could change for the better if Trump succeeds in cutting the corporate tax rate. This rate is probably effectively higher for SBOs than large corporations, which have more resources for gaming the tax system to their advantage. Let’s take a deeper dive into the survey, which is much more fun than doing the same into Washington’s swamp:

(1) *Future looking up.* When I was an undergraduate at Cornell, I read a novel by a former Cornelian, Richard Fariña, titled *Been Down So Long It Looks Up to Me*. Sadly, he died in a motorcycle accident two days after his book was published by Random House. But I digress. SBOs have been mostly depressed during the current economic expansion, but now are looking up again. The percentage expecting better rather than worse business conditions six months ahead was mostly negative since 2009 ([Fig. 3](#)). This diffusion index shot up from -7.0% during October to 47.0% in February. The net percentage expecting higher real sales in six months jumped from 1.0% during October to 26.0% during February ([Fig. 4](#)).

(2) *Expansion plans.* That’s influencing SBOs’ decisions to expand over the next three months, with this diffusion index jumping from 9.0% during October to 22.0% last month ([Fig. 5](#)). That’s great news. However, their new number-one problem may be finding workers. During February, 32.0% of SBOs said that they have one or more job openings, the highest since February 2001 ([Fig. 6](#)).

(3) *Full employment.* Last month, the percentage of SBOs with positions that they were unable to fill, based on the three-month average of this volatile series, rose to 30.7%, also the highest since February 2001 ([Fig. 7](#)). This series happens to be highly inversely correlated with the official unemployment rate,

which has been below 5.0% for the past 10 months. In other words, it is confirming that the economy is probably at full employment.

Earnings: Industry Analysts More Bullish. There are plenty of other soft data showing animal spirits, including surveys of consumer confidence, purchasing managers, and regional businesses. February's better-than-expected increase in employment measures was widely attributed to mild weather boosting construction payrolls.

Meanwhile, our Boom-Bust Barometer (BBB), which is the ratio of the CRB raw industrials spot price index to initial unemployment claims, continues to boom ([Fig. 8](#)). Debbie and I consider it to be one of the most reliable, high-frequency, hard-data business-cycle indicators. It has gone almost rocket-ship vertical since bottoming during the week of January 16, 2016. It is up 50% through early March.

Our BBB is based on hard rather than soft data. The S&P 500 stock price index has been highly correlated with it since 2000 ([Fig. 9](#)). That's because our BBB has been highly correlated with S&P 500 forward earnings ([Fig. 10](#)). Needless to say, it is wildly bullish for earnings and for stocks, though it does tend to be more volatile than both. For now, S&P 500 forward earnings continues to climb into record-high territory. Let's review the latest data:

(1) *Looking at forward earnings.* S&P 500 forward earnings remained at a record high of \$133.99 last week ([Fig. 11](#)). This metric is a good year-ahead leading indicator of four-quarter trailing earnings, as measured by Thomson Reuters, with just one important proviso: It doesn't anticipate recessions. As the year progresses, it will converge toward the analysts' consensus expected earnings for 2018 ([Fig. 12](#)). Their 2018 estimate has been remarkably stable since Election Day around \$146 per share, while the 2017 estimate has continued to decline, as is typical for annual estimates.

Industry analysts may be assuming that Trump's tax reform will boost earnings in 2018. Joe and I are still estimating \$143 per share for this year's earnings and \$150 for next year. If the corporate tax cut doesn't hit until next year, then this year's figure will be around \$130 and next year's will still be \$150, in our opinion. As we've previously written, the timing shouldn't matter much, since by the time we know whether tax reform is or is not retroactive to 2017, the market will be focusing increasingly on 2018. (See [YRI S&P 500 Earnings Forecast](#).)

(2) *Looking at forward revenues.* S&P 500 forward earnings is rising in record-high territory because forward revenues is doing the same ([Fig. 13](#)). Analysts are expecting revenues per share to rise 5.7% in 2017 and 4.8% in 2018. The estimates for both years have been holding up quite well in recent weeks. While a cut in the corporate tax rate directly boosts earnings, it can have only an indirect impact on revenues. In other words, some of the animal spirits in next year's consensus earnings estimate may reflect a more constructive outlook for the global economy, which drives revenues.

(3) *Looking at 2017 earnings.* The one downer in the weekly data that Joe and I track is the 3.5% drop in the consensus estimate for Q1-2017 since the beginning of the year ([Fig. 14](#)). This is a typical occurrence, and typically sets the upcoming earnings season for an upside "hook" once the actual results are reported. In any event, industry analysts currently predict that 2017 earnings will be up 10.7% over 2016, with the following quarterly profile: Q1 (9.5%), Q2 (8.5), Q3 (9.0), and Q4 (13.0). Of course, if the price of oil continues to drop, that could weigh on earnings, though not as much as during 2015.

CALENDARS

US. Wed: Retail Sales Total, Ex Autos, Ex Autos & Gas 0.2%/0.2%/0.3%, Business Inventories 0.3%,

Empire State Manufacturing Index 15.7, Headline & Core CPI 2.7%/2.2% y/y, Housing Market Index 66, MBA Mortgage Applications, Treasury International Capital, EIA Petroleum Status Report, FOMC Meeting Announcement. **Thurs:** Jobless Claims 240k, JOLTS, Housing Starts & Building Permits 1.270mu/1.267mu, Philadelphia Fed Manufacturing Index 30.0, Weekly Consumer Comfort Index, EIA Natural Gas Report. (Bloomberg estimates)

Global. Wed: UK Employment Change & Unemployment Rate 80k/4.8%, Japan Industrial Production. **Thurs:** Eurozone Headline & Core CPI 2.0%/0.9% y/y, Eurozone Car Sales, Japan Machine Tool Orders, Australia Employment Change & Unemployment Rate 16.5k/5.7%, BOE Rate Decision & Asset Target Rate 0.25%/435b, BOJ Policy Balance Rate & 10-Year Yield Target Rate. (DailyFX estimates)

STRATEGY INDICATORS

S&P/Russell LargeCaps & SMidCaps ([link](#)): All these price indexes attained record highs following the election as the SmallCap and MidCap market-cap indexes outperformed LargeCaps. However, SmallCaps are underperforming so far in 2017. Here's the ytd score and their percentage changes since Election Day: Russell MidCap (4.4% ytd, 10.4% since the election), Russell LargeCap 1000 (5.9, 11.0), S&P LargeCap 500 (6.0, 10.9), S&P MidCap 400 (3.2, 13.2), Russell SmallCap (1.0, 14.7), and S&P SmallCap 600 (-0.5, 14.8). 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 8.2% y/y from 8.1%, which compares to a six-year low of -1.8% in October 2015; MidCap's improved to a 27-month high of 10.4% from 9.5%, which compares to a six-year low of -1.3% in December 2015; and SmallCap's rose to 12.3% from 12.1%, which compares to a 31-month high of 12.5% in late February and 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 10.7% and 12.2%, MidCap 10.0% and 13.2%, and SmallCap 11.0% and 18.9%.

S&P 500 Growth vs. Value ([link](#)): The S&P 500 Growth index is up 7.9% ytd, ahead of the 3.9% gain for its Value counterpart. Since the election, Growth's 9.9% gain has trailed the 11.8% increase for Value. During 2016, the S&P 500 Growth index underperformed its Value counterpart by a wide margin, rising just 5.1% vs Value's 14.3% gain. Growth is expected to deliver higher forward revenue growth (STRG), but lower forward earnings growth (STEG), than Value over the next 12 months: (6.2% STRG and 9.2% STEG for Growth, respectively, vs 5.1% and 12.0% for Value). Growth's P/E of 20.0 and Value's at 16.2 are both at 14-year highs. Regarding NERI, Growth's has been negative for four straight months and improved to -3.0% in February from a nine-month low of -5.5% in January; that compares to a five-year high of 5.8% in June 2016 and a five-year low of -16.2% in April 2015. Value's NERI was negative for a 31st straight month in February, and dropped to a five-month low of -2.8% from -1.7% in January; that compares to a 10-month low of -18.0% in February 2016 and a five-year low of -20.3% in April 2015.

US ECONOMIC INDICATORS

NFIB Small Business Survey ([link](#)): Small business optimism in February slipped a bit, but remained at one of its highest readings in 43 years, according to the NFIB report. However, restrictive government policies are preventing businesses from following through on their optimism. NFIB's president notes, "Small businesses will begin to turn optimism into action when their two biggest priorities, health care and small business taxes, are addressed." February's Small Business Optimism Index (SBOI) gave back 0.6 point to 105.3—after soaring from 94.1 in September to 105.9 in January—which was the highest since December 2004. Last month, there were no big moves up or down among the 10 components of the index, with the range between 1ppt and 3ppts. Three of the 10 components increased, six declined, while expected credit conditions (-3%) was unchanged. The three positive

contributors were current inventory (to -2% from -5%), plans to increase inventories (3 from 2), and current job openings (32 from 31); the latter's reading is at its highest for this recovery and indicates one of the tightest labor markets in the 43-year history of the survey.

PPI ([link](#)): The PPI for final demand in February rose 0.3%, half January's 0.6% increase. February's gain reflected a 0.4% increase in final demand services—the largest since June 2016—accounting for over 80% of the gain in the final demand index; final demand goods rose 0.3%, less than one-third the pace of January's 1.0% gain. Nearly 70% of the increase in final demand services can be traced to prices for final demand services less trade, transportation & warehousing (0.5%); traveler accommodation services jumped 4.3%. The increase in final demand goods was widespread, but over half of the gain was energy-related, with the index for electric power surging 1.6%. The yearly inflation rate for the headline series accelerated 2.2% y/y, the largest increase since March 2012. The goods rate (2.9% y/y) was the highest since January 2012, while the services rate (1.4) remained in a volatile flat trend. The rates for the core (1.5) and core ex trade services (1.8) held around recent highs.

GLOBAL ECONOMIC INDICATORS

Eurozone Industrial Production ([link](#)): The rebound in January output was less than expected, though December's slump was smaller than first reported. Industrial production (excluding construction) climbed 0.9% after falling a revised 1.2% (versus -1.6%) in December from November's cyclical high. January's advance was driven by solid gains in capital goods (2.8%) and energy (1.9) output, which were partially offset by losses in consumer nondurable (-0.7), consumer durable (-0.4), and intermediate (-0.4) goods output. Consumer durable goods output had surged 4.7% the previous three months. As for production in the four largest Eurozone economies, Germany (3.3%) recorded one of the largest increases, while Italy (-2.3) posted a sizeable decline; Spain's industrial production rose 0.3%, while France's fell 0.3%. Of the remaining countries for which data are available, Ireland (3.4) and Greece (2.5) joined Germany on the biggest gainers list, while Latvia (-2.8), Luxembourg (-2.3), and the Netherlands (-1.7) joined Italy on the biggest losers list.

Mexico Industrial Production ([link](#)): Industrial production in Latin America's second-largest economy remained volatile around record highs in January, while factory output set another new record high. Headline production ticked up 0.1% after ticking down by the same amount in January, as gains in mining (1.1%) and manufacturing (0.5) production more than offset a 2.0% drop in utilities; construction output was unchanged. For manufacturing, it was the eighth increase in nine months for a total gain of 4.6%. On a y/y basis, headline production fell 0.1%—continuing to bounce around zero as mining output plunged 9.8%, near its cyclical low posted at the end of last year, and construction (-1.0) output fell back below zero; manufacturing (4.3) and utilities (1.0) output remained above year-ago levels.

Contact us by [email](#) or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor & Webmaster, 570-775-6823

Copyright (c) Yardeni Research, Inc. Please read complete [copyright and hedge clause](#).