



## MORNING BRIEFING

March 28, 2017

### Bumps & Slumps

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

(1) Will failed ACA-R&R be followed by delayed and diminished (D&D) tax reform? (2) Plenty of time left for Trump to get it right, or wrong. (3) No harm, no foul for Trump on ACA. (4) Dollar remains strong despite recent slump. (5) End of energy recession early last year more bullish than Trump's election, so far. (6) Low oil prices might finally be stimulating rather than depressing global economy. (7) Bond yields and stock prices may be slumping on lower oil prices. (8) Financials and Industrials clearly enjoyed Trump bumps, and now paying with slumps. (9) US stocks could slump for a short while relative to foreign ones.

**Strategy: From R&R to B&S?** This week may be dominated by the fallout from the failure of the Republicans to repeal and replace (R&R) Obamacare (a.k.a. the Affordable Care Act, or ACA) at the end of last week. The good news is that it didn't take very long to cripple this flawed legislative initiative, which means that the Trump administration can move forward with tax reform much sooner than had been widely expected. The bad news is that the perception, right or wrong, is that the new administration has been greatly weakened by the implosion of their ACA-R&R initiative. It's too soon to be sure of that. It's also too soon to be sure that Obamacare won't implode, as Trump has often claimed it would. If it does so, then he will be in a better position to repeal and replace it at that point.

For now, the so-called "Trump bump" in the financial markets may be turning into a "Trump slump." Putting it all together: The Trump slump is replacing the Trump bump because Trump is having trouble draining the swamp. Joe and I are sticking with our assumption that a combination of deregulation and tax cuts will significantly boost S&P 500 earnings this year and next year. We still expect that tax cuts will happen this year, on a retroactive basis. If they don't take effect until next year, however, we won't know that until this summer, at which point the effective date won't matter much to stocks: Either way would be just as bullish since investors by then will be focusing increasingly on 2018 anyway.

Debbie and I believe that the surge in animal spirits, as evidenced by all the soft-data economic [surveys](#), is driven mostly by the perception that the new administration is very pro-business and anti-regulators. That hasn't changed notwithstanding the failure of ACA-R&R. High hopes for significant tax reform might suffer a slump, but that's not inevitable. If Obamacare remains the law of the land and succeeds, then Trump can say "no harm, no foul." If it fails, he can say "I told you so." Of course, Trump is still in a position to tweak the ACA with executive and regulatory actions that could either save it from a death spiral or speed up its demise.

Animal spirits could trickle down to boost the hard data on consumer spending, durable goods orders, and housing starts. Debbie and I are still forecasting that the US Treasury 10-year yield should continue to trade between 2.0%-2.5% during the first half of this year and rise to 2.5%-3.0% during the second half of the year. The Fed is likely to proceed with two more rate hikes later this year.

In any event, the economy is at full employment, so it doesn't need a lot of fiscal stimulus. Too much could boost expected and actual inflation, though we continue to see very powerful structural forces keeping a lid on inflation, including competitive, demographic, and technological ones. Now, let's review

how the financial markets are interpreting all the developments since Election Day:

(1) *Currencies*. The JP Morgan trade-weighted dollar jumped 5.4% from 119.78 on November 8 to a recent peak of 126.21 on January 11 ([Fig. 1](#)). It then fell 4.2% through Monday to the lowest level since Election Day. It is widely assumed that mounting uncertainty about Trump's agenda may cause the Fed to slow the pace of rate hikes. This might explain why the dollar's Trump bump has been followed by the recent slump.

In any event, the dollar is still up 21% since July 1, 2014, the start of its latest significant ascent. So the recent weakness in the dollar may reflect long-overdue rebounds in the euro, the yen, and the pound. In other words, it may also have something to do with developments in Europe and in Japan rather than just in the US.

The euro is up from a recent low of 1.04 to 1.09 on Monday ([Fig. 2](#)). That might have something to do with the remarkable strength in the latest batch of Eurozone economic indicators. As Debbie and I reviewed yesterday, the composite PMI for the region rose to 56.7 during March, led by France (57.6) and Germany (57.0) ([Fig. 3](#)). Germany's Ifo business confidence index rose to 112.3 this month, the highest since July 2011 ([Fig. 4](#)). The current situation component of the index has been especially strong for the past seven months.

(2) *Commodities*. On March 17, the CRB raw industrials spot price index rose to the highest level since September 23, 2014 ([Fig. 5](#)). There's no slump in this index, which is confirming—along with Germany's Ifo business survey—that the global economy has recovered nicely from the global energy-sector recession that ended in early 2016. Joe and I have been arguing that the end of the energy-led earnings recession last summer has been at least as important as political developments in Washington since November 8.

The CRB index cited above does not include any petroleum products. The price of a barrel of West Texas crude oil rebounded 108% from a low of \$26.21 on February 11, 2016 to a high of \$54.45 this year on February 23 ([Fig. 6](#)). Yesterday, it was back down to \$47.85. This slump might be partly attributable to Trump, who has moved forward aggressively with deregulating the energy industry in the US.

On Thursday, Jackie reviewed Trump's latest actions on this front: "In his first month on the job, he signed executive memos that make it easier for TransCanada to construct the Keystone XL pipeline and for Energy Transfer Partners to build the remainder of the Dakota Access pipeline. He also signed House Joint Resolution 41, eliminating a federal rule that requires energy companies to disclose royalties and government payments. .... The EPA under Scott Pruitt has repealed a rule enacted under Obama that required oil and natural gas companies to provide the EPA with information about methane emissions. .... The administration has said it plans to roll back an Obama rule requiring companies that drill for oil and natural gas on federal lands to disclose chemicals used in fracking [and] .... also pledged to revive the coal industry using clean coal technology."

A more likely explanation for the recent slump in the price of oil is that the US oil rig count has rebounded 106% from a low of 316 units during the final week of May 2016 to 652 in mid-March ([Fig. 7](#)). US oil field production, which fell only 12.3% during the energy recession, has rebounded to 9.1 million barrels in mid-March, only 5.0% below its peak during the week of June 5, 2015. There's no slump in US crude oil inventories, which hit another record high in mid-March ([Fig. 8](#)).

Oil prices and fuel prices remain well below their 2014 highs. Now that the energy recession is over, the benefit of low energy prices may be stimulating world economic growth. That's bullish for the stock

market. It's not bad for the bond market since low oil prices help to keep a lid on inflation. Trump may simply have lucked out with all these global economic forces going his way just in time and providing lots of support for the stock market's Trump bump, which owes a lot to Trump, but not everything to him.

(3) *Bonds*. The 10-year US Treasury bond yield was 1.88% on Election Day ([Fig. 9](#)). It rose to a high this month of 2.62% on March 13. Yesterday, it was back down to 2.38%, presumably because Trump's fiscal stimulus agenda may be delayed and diminished (D&D) by the failure to R&R Obamacare. That may be part of the story. Another is that on Wednesday, March 15, Fed Chair Janet Yellen came across as more dovish than was expected at her press conference.

The recent drop in the price of oil may also be reducing inflationary expectations. There certainly was a Trump bump in expected inflation in the 10-year Treasury bond market. The spread between the nominal and TIPS yields widened from 173bps on Election Day to a high of 208bps on January 27 ([Fig. 10](#)). Yesterday, it had edged down to 197bps.

(4) *S&P 500*. What has been more bullish so far: The end of the energy recession or the election of Donald Trump? This isn't a trick question, and the answer is obvious. The price of a barrel of WTI crude oil bottomed last year on February 11 at \$26.21. It is up 83% since then. The S&P 500 is up 28.0% through yesterday's close since the price of oil troughed. It is up 9.4% since Election Day.

Renewed fears of a slump in oil prices might have more to do with the 2.3% slump in the S&P 500 through Friday's close since it hit a record high of 2395.96 on March 1 than with anything happening in DC. In any event, Joe and I are still forecasting that the S&P 500 will rise to 2400-2500 by the end of the year. Of course, the index would have to rise just 2.5% to hit the bottom of that range, while the top would require a 6.8% advance. A spring slump in stock prices would be the pause that refreshes, in our opinion, giving earnings a chance to reduce highly elevated valuation multiples.

(5) *S&P 500 sectors*. Not surprisingly, the S&P 500 Energy sector led the stock index higher last year once the price of WTI crude oil bottomed on February 11. From then until last year's peak for Energy on December 13, the sector rose 40.3%, outpacing the S&P 500's 24.2% gain over the same period ([Fig. 11](#)). Since then, the Energy sector has weighed on the S&P 500, with a decline of 12.1%.

However, S&P 500 Financials and Industrials are two sectors that clearly enjoyed a remarkable Trump bump and now are slumping. The former soared 26.0% since Election Day through March 1, while the latter jumped 14.0% over the same period. Since then, both are down by 6.8% and 3.6%, respectively.

(6) *Foreign stock markets*. Joe and I are still recommending a "Stay Home" investment strategy. However, we are getting cabin fever and seeing cheaper stocks abroad. Here are the forward P/Es for some of the major MSCI stock market indexes: US (18.2), Japan (14.5), EMU (14.4), UK (14.3), and Emerging Markets (12.0) ([Fig. 12](#)).

The relative performance of the US index may be starting to slump because of mounting uncertainty about Trump's economic agenda ([Fig. 13](#)). There's no shortage of uncertainties overseas, of course. While Europe may be cheaper than the US, populist movements have been gaining political power in the region, and threaten to disintegrate both the Eurozone and the European Union. However, this may be a relatively low risk for now, which might allow Europe to outperform the US, especially in dollar terms.

## CALENDARS

**US. Tues:** Advance Merchandise Trade Balance -\$66.5b, Consumer Confidence 113.5, Richmond Fed Manufacturing Index 15.0, S&P Corelogic Case-Shiller HPI 0.8%/m/m/5.7%/y/y, Kaplan. **Wed:** Pending Home Sales 1.8%, MBA Mortgage Applications, EIA Petroleum Status Report, Evans. (Bloomberg estimates)

**Global. Tues:** Japan Retail Trade 0.3%/m/m/0.7%/y/y. **Wed:** Japan Small Business Confidence. (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—was little changed during the week of March 18 for the third week after a ten-week surge, totaling 10.1%, to a new record high. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). Our BBB fell for the second time in three weeks by a total of 2.4%, after rising eight of the prior ten weeks by 15.8% to a new record high. The recent weakness reflects a rise in jobless claims for the third week to 246,500 (4-wa) after sinking to 239,750 three weeks ago—which was the lowest since 1973. The CRB raw industrials spot price index—another BBB component—moved higher during the latest reporting week, though has stalled in recent sessions. Meanwhile, the WCCI has surged seven of the past eight weeks, by a total of 13.5%, to a new record high.

**S&P 500/400/600 Forward Earnings** ([link](#)): Forward earnings rose last week to record highs for LargeCap and MidCap. SmallCap's was up for the second time in six weeks to 0.9% 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 30-month high of 8.4% y/y from 8.3%, which compares to a six-year low of -1.8% in October 2015; MidCap's was steady at a 30-month high of 10.6%, which compares to a six-year low of -1.3% in December 2015; and SmallCap's jumped to a 34-month high of 12.8% from 12.2%, 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 10.8% and 12.1%, MidCap 9.5% and 13.2%, and SmallCap 10.0% and 19.9%.

**S&P 500/400/600 Forward Valuation** ([link](#)): Valuations fell across the board last week, but remain slightly below recent 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 fell to a six-week low of 17.4 from 17.7, down from a 13-year high of 17.8 in early March. 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 fell to an 18-week low of 18.4 from 18.8; that compares to a 15-year high of 19.2 in late February and the record high of 20.6 in January 2002, but is up from a three-year low of 15.0 in January 2016. SmallCap's dropped to an 18-week low of 19.4 from 20.0; 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, when Energy's earnings were depressed, and a record high of 20.9 in April 2002. 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 1.33 are close to their recent record highs of 1.94 and 1.37, while SmallCap's 1.05 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 picked up last week for the S&P 500 sectors as analysts made slight adjustments ahead of the upcoming quarterly earnings season. The Q1 consensus rose w/w for one of the 11 S&P 500 sectors, was steady

for three, and fell for seven. Telecom rose 1.0% w/w, and these three were steady: Consumer Staples, Energy, and Utilities. Sectors with the biggest w/w percentage declines in their Q1 forecasts: Consumer Discretionary (-4.2%), Real Estate (-1.8), and Materials (-0.4). The S&P 500's Q1-2017 EPS forecast fell 1 cent w/w to \$29.51, and is down 3.5% from \$30.53 at the end of Q4. That represents a forecasted pro forma earnings gain of 10.4% y/y, the strongest growth since Q3-2011, with the forecast up from 10.2% a week earlier and down from 13.8% at the end of Q4. Since the end of Q4, Q1 estimates are higher for 1/11 sectors and lower for 10/11. The Q1 forecast for Real Estate is up 0.9%, and Tech has edged down only 0.4%. Industrials is down the most (-7.6), followed by Consumer Discretionary (-7.2), Materials (-5.5), Consumer Staples (-4.1), Health Care (-4.0), and Energy (-2.5). The S&P 500's Q1-2017 forecasted earnings gain of 10.4% 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 10.4%. That's an improvement from the 9/11 sectors rising y/y during Q4-2016 and Q3-2016, and compares to 6/10 rising during the quarters from Q4-2015 to Q2-2016. 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 at the end of January. 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. 5.3% in Q4), Financials (15.9% vs. 11.6%), Tech (15.0, 12.7), Materials (12.8, 7.1), S&P 500 (10.4, 8.0), Industrials (5.5, -0.9), Health Care (2.6, 7.2), Telecom (2.2, -0.2), Consumer Staples (2.5, 7.2), Real Estate (1.5, 8.6), Utilities (1.0, 10.1), and Consumer Discretionary (1.2, 5.3).

**S&P 500 Q1 Earnings Trend vs. Past Quarters** ([link](#)): With the March-quarter books closing at the end of the week, the current Q1-2017 EPS forecast of \$29.51 has dropped 3.5% over the 13 weeks since the quarter's start. That marks the 24th straight quarter that forecasts have fallen, but is well above the average 4.3% decline in the quarter's estimate since 1994. Analysts expect EPS for Q1-2017 to be up 9.5% y/y on a frozen actual basis, better than the 6.0% gain for Q4-2016 and the third straight quarter of higher EPS on a y/y basis. However, we think that Q1's EPS will be \$29.75 and that earnings will rise 10.3% y/y for the first double-digit growth quarter since Q3-2011. Since 1994, the Q1 earnings surprise has been positive in 22/23 years (all but 2008). We think Q1 will mark the S&P 500's 33rd straight quarter of positive surprises—a streak dating back to Q1-2009 and longer than the prior 10-quarter positive surprise streak (Q1-2003 to Q2-2005).

## US ECONOMIC INDICATORS

**Regional M-PMIs** ([link](#)): Four Fed districts so far have reported on manufacturing activity for March—New York, Philadelphia, Kansas City, and Dallas—and show the sector continued to expand at a robust pace, though not as fast as February's hot pace. We average the composite, orders, and employment measures as data become available. The composite index slipped to 21.5 this month from 25.1 last month—which was the highest reading since the end of 2004. The Kansas City measure (to 20 from 14) jumped to a six-year high, while the Philadelphia (32.8 from 43.3) and New York (16.4 from 18.7) measures slowed slightly after improving dramatically in February; Dallas' (16.9 from 24.5) eased from February's more-than-a-decade high. Meanwhile, the orders and employment indexes continued to pick up. The new orders index (25.4 from 22.3) accelerated for the eighth consecutive month, reaching its fastest pace since March 2006. The Philadelphia (38.6 from 38.0), Kansas City (32 from 26), and New York (21.3 from 13.5) gauges showed the fastest growth since December 1987, December 2003, and April 2010, respectively. Dallas' (9.5 from 11.6) growth rate slowed for the second month. The employment index (11.9 from 9.9) was positive for the third month—after negative readings the prior 18 months—at its highest level since July 2014. Philadelphia's (17.5 from 11.1) gauge showed job gains were the fastest in nearly two years, while New York's (8.8 from 2.0) showed manufacturers adding to payrolls for the second month after cutting jobs the previous seven months; Kansas City's (13 from 17) and Dallas' (8.4 from 9.6) slowed a bit from recent highs.

## GLOBAL ECONOMIC INDICATORS

**Germany Ifo Business Climate Index** ([link](#)): German businesses haven't been this optimistic in nearly six years. The Ifo business climate index this month was a surprise on the upside, climbing to 112.3 (the highest since July 2011) from 111.1 in February and 109.9 in January. Businesses were more optimistic about both the present and the future. The present situation component advanced for the seventh consecutive month from 113.1 in August to 119.3 this month—the highest since July 2011. The expectations component rose for the second month from 103.2 in January to 105.7 in March, back near its cyclical peak of 106.0 recorded last October. The German economy appears to be firing on all cylinders. Yesterday's Ifo report follows last week's release of Markit's PMIs, which showed Germany's private sector also grew at its fastest pace in nearly six years, with its Composite Output Index (57.0) and M-PMI (58.3) the highest in 70 and 71 months, respectively, and the NM-PMI (55.6) at a 15-month high. Ifo's expectations component correlates closely with German factory orders and production; the overall index tracks exports more closely. Recent Ifo data indicate a continued pickup from last summer's slowdown, as sentiment brightened again in March.

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