



MORNING BRIEFING

May 18, 2017

Fall from Grace

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

(1) Yesterday's fall. (2) Seeking impeachable offenses. (3) Loose Lips Donald. (4) White House busy playing whack-a-mole all day. (5) Keeping targets for S&P, but swapping 2017 & 2018 for earnings. (6) Adam & Eve & Trump. (7) The Swamp of Eden. (8) Tech has been chosen for great things. (9) Software for the cloud. (10) Chips for the cloud.

Strategy: Original Sin. Yesterday was the first day since Election Day that stock market investors started to discount the possibility that everyone in Washington is losing their minds. The place has been unhinged for a very long time, but it seems to have gotten much worse since Donald Trump occupied the White House on January 20. Indeed, there seem to be a very large contingent of Democrats who believe that it is an occupation and that Trump's presidency is illegitimate. Their not-so-subtle objective seems to be to get him impeached.

During World War II, posters warned American citizens: "Loose Lips Sink Ships." Now there is buzz that Trump's loose lips could sink his presidency from the get-go, before he gets to go on with his agenda. Everything he says or tweets triggers a daily firestorm of media pundits declaring that Trump has gone too far. For many of them, Trump was always a sinner, so from their perspective he had already fallen from grace. White House spokespersons have been ineptly playing whack-a-mole, trying to beat down the latest innuendos inspired by their all-too-talkative commander-in-chief.

I am not a preacher, so I don't do right vs wrong. As an investment strategist, I do bullish vs bearish. Up until yesterday, the stock market seemed to tune out the ear-splitting noise coming out of Washington since Election Day. Instead, investors focused on the signal, which has been Trump's commitment to cut corporate taxes. Now that Trump seems to be increasingly getting sucked up by the swamp rather than draining it, investors are losing confidence in his ability to get much of anything done for a while. The one important exception is deregulation, which remains a bullish development for the stock market. Furthermore, as Joe and I have been chronicling, the US and global economies are growing, and so are S&P 500 revenues and earnings.

So, notwithstanding the worsening cacophony coming out of our nation's capital, Joe and I are sticking with our S&P 500 stock price target of 2400-2500 for this year. On Monday of this week, the index closed at a record high of 2402.32. Under the circumstances, we must change our S&P 500 earnings forecasts. We still expect a significant corporate tax cut, but it is less likely to boost earnings this year than next year. If earnings are not boosted until next year, then instead of \$142.00 per share this year, our estimate would be \$129.00. But next year, earnings could be \$150.00 rather than \$136.75. That would bring us closer in line with the latest consensus of industry analysts for this year and next year at \$131.57 and \$147.10.

The Founding Fathers created a political system of checks and balances, which is often called "gridlock" these days. Ironically, it may be more gridlocked now than ever before, even though the Republicans have the White House and majorities in both chambers of Congress as well as the

Supreme Court! The Founders were realists and recognized that humans are not angels. So they designed a political system to govern humans, whom they judged had long ago fallen from grace. It all started when Adam and Eve disobeyed the Good Lord and ate the apple from the Tree of Knowledge.

Trump's adversaries are hoping for a similar "gotcha moment." They seem to believe that they have it in "Comey's Revenge," which is reportedly a note-to-self written by the Trump-ousted former FBI director. Second-hand sources claim that the note claims that Trump asked James Comey to stop investigating former National Security Adviser Michael Flynn shortly after Flynn had resigned. If true, that would clearly be an obstruction of justice by the President. Not so clear is why Comey kept the note on file until he was fired, and whether a request is the same as an order. This may or may not be the beginning of Trump's expulsion from the Swamp of Eden.

Tech I: The Chosen One. If you believe in market lore, Apple has a lot stacked against it. It's the most valuable company in the S&P 500, and it just opened a swanky headquarters that cost roughly \$5 billion to build. To a contrarian, those are warning signs of immense proportions. A company never holds the "Largest Market Cap" title forever, and shiny new headquarters often precede corporate downfalls. Apple may have just taken a bite out of the forbidden fruit!

For the past five years, Apple has had the S&P 500's largest market cap, according to Joe's figures. Before that, ExxonMobil was the top dog from 2006 through 2011 as oil prices surged. From 1993 through 1997 and then again in the early years of this century, General Electric had the largest market cap. Its tenure was interrupted by Microsoft in 1998, 1999, and 2002. Go back further, and you'll find IBM and AT&T once had the S&P's largest market caps. Now neither stock cracks the top 10.

What's interesting about today's market is that if Apple does lose its top-market-cap title, the mantle will probably pass to yet another tech titan. Alphabet, parent to Google, has the second-largest-market capitalization, and in third and fourth places are Microsoft and Amazon, which technically is a Consumer Discretionary stock but arguably has more in common with its tech cousins. Right behind them in fifth place is Facebook.

Fortunately for our market-cap-weighted indexes, these tech giants are in serious rally mode. On Tuesday, Nasdaq hit its 33rd record this year. It's up 14.6% ytd through Tuesday's close and 30.8% y/y. While stellar, Nasdaq's performance understates the strength of Tech. The S&P 500 Tech sector is the top-performing sector over the past year, up 37.9%, more than double the S&P 500's 17.3% return over the same period.

Here's how the S&P 500 sectors have performed over the past year through Tuesday's close: Tech (37.9%), Financials (28.0), Industrials (19.3), S&P 500 (17.3), Materials (15.5), Consumer Discretionary (14.9), Health Care (9.0), Utilities (4.3), Consumer Staples (3.7), Energy (2.7), Real Estate (-1.8), and Telecom Services (-6.6) ([Table 1](#)).

The S&P 500 Tech sector is also one of only four sectors that have enjoyed total returns that bested the S&P 500 since the market bottomed in 2009. The S&P 500 Consumer Discretionary sector has outperformed the S&P 500 by 222.3% since 2009. Other sectors outpacing the index include Financials (122.4), Tech (118.4), and Industrials (95.1). The other sectors have underperformed the S&P 500 since 2009: Health Care (-18.8%), Materials (-57.6), Consumer Staples (-63.4), Utilities (-103.6), Telecom (-152.2), and Energy (-226.9) ([Fig. 1](#)).

There were some significant haircuts as a result of yesterday's selloff. Here's Wednesday's performance derby: Real Estate (0.6%), Utilities (0.2), Consumer Staples (-0.2), Energy (-1.1), Health Care (-1.3), Consumer Discretionary (-1.6), Telecom Services (-1.8), S&P 500 (-1.8), Industrials (-2.1),

Materials (-2.1), Information Technology (-2.8), and Financials (-3.0). For now, let's take a look at what's driving some of Tech's amazing outperformance over the past year:

(1) *Rising revenue.* The Tech sector is expected to have revenue growth of 8.0% over the next 12 months, the second best among the 11 S&P 500 sectors and behind only Energy, which is poised for a revenue rebound now that the price of oil has bounced back from the low of \$27.88 per barrel in January 2016. Here's how the S&P 500 sectors' forward revenue growth stacks up: Energy (14.6%), Tech (8.0), Real Estate (5.9), S&P 500 (5.3), Materials (5.3), Consumer Discretionary (4.8), Health Care (4.8), Utilities (4.0), Industrials (3.8), Financials (3.6), Consumer Staples (2.8), and Telecom (-0.9) ([Table 2](#)).

(2) *Great margins.* One of the benefits that many Tech industries enjoy is strong profit margins. Many Tech companies produce software, whether it be Microsoft, Google, or Facebook. Their lack of physical inventory typically results in above-market margins. The Tech sector is expected to have profit margins over the next 12 months of 20.3%, better than any other sector in the S&P 500. Here are how the sectors' margins rank: Tech (20.3%), Real Estate (16.9), Financials (16.3), Telecom (11.4), Utilities (11.0), S&P 500 (10.9), Health Care (10.5), Materials (10.4), Industrials (9.4), Consumer Discretionary (7.6), Consumer Staples (6.9), and Energy (5.2).

(3) *Charged-up earnings.* Strong revenue growth plus market-leading margins means healthy earnings growth should be in the cards. The Tech sector is expected to grow earnings 11.1% over the next 12 months, behind only the Financials, Materials, and Energy sectors. Here what's expected for forward earnings in the S&P 500 sectors: Energy (122.9%), Materials (13.5), Financials (12.4), S&P 500 (11.2), Tech (11.1), Consumer Discretionary (9.2), Industrials (8.8), Consumer Staples (7.0), Health Care (6.8), Utilities (2.7), Telecom Services (0.3), and Real Estate (-16.6) ([Fig. 2](#)).

Analysts have revised upward their expectations for Tech forward earnings by 1.3% over the past four weeks, Joe points out. That's a bit less than the upward revisions enjoyed by Real Estate (2.6%), Industrials (2.6), Energy (2.5), and Materials (1.4), but it's on par with the S&P 500 (1.3) and ahead of the other sectors: Financials (1.2), Health Care (1.1), Consumer Discretionary (1.0), Utilities (0.8), Consumer Staples (0.7), and Telecom (-1.4).

The Tech sector has pumped out better earnings growth than other sectors for most of the past eight years if the Auto industry is excluded from the Consumer Discretionary sector. The exceptions: 2010 and 2011, when the Materials sector outperformed ([Fig. 3](#)).

(4) *In-line valuation.* The Tech sector's forward P/E has improved from 11.8 on April 18, 2013, but it remains only slightly ahead of the broader market's multiple. The Tech sector's forward P/E is 18.4 as of May 11 vs the S&P 500's forward P/E of 17.6. Here's the P/E performance derby for the rest of the gang: Real Estate (38.4), Energy (25.8), Consumer Staples (20.1), Consumer Discretionary (19.6), Tech (18.4), Industrials (17.7), Materials (17.7), S&P 500 (17.6), Utilities (17.6), Health Care (15.7), Financials (13.5), and Telecom (13.0) ([Fig. 4](#), [Fig. 5](#), [Fig. 6](#), and [Fig. 7](#)).

Tech II: Heavenly Cloud. Like most sectors, Tech has some industries that are performing much better than others. Just looking at the next 12 months, Tech industries with the fastest consensus expected earnings growth include S&P 500 Application Software (20.6%), Electronic Equipment & Instruments (16.9), Semiconductor Equipment (15.8), Data Processing & Outsourced Services (14.2), Technology Hardware, Storage & Peripherals (12.3), and Semiconductors (12.0). Let's take a look at what's driving some industries boasting the fastest earnings growth:

(1) *Heading to the clouds.* It's no longer enough to write excellent software programs. Today those

programs have to be available for purchase or for subscription in the cloud. The transition isn't always easy, but done well it can be profitable. Among the companies in the Application Software Industry, the top performer over the past year has been Autodesk, up almost 70%.

Once known for making technical drawings, the company has evolved into one that creates industrial-design software for engineers, game developers, and movie special effects artists that can be bought outright or as a subscription. The shares were also pushed ahead by the involvement of activist firm Eminence Capital.

Autodesk also has a hand in the world of artificial intelligence with its Dreamcatcher system. "The system creates designs after users enter certain performance desires, materials and the tooling available," explains a 3/12 [WSJ article](#). "Researchers at Autodesk created a proof-of-concept car part that was about 35% lighter than the original that could be used to connect a vehicle chassis to the wheel. Autodesk has also used Dreamcatcher to design a chair inspired by Hans J. Wegner's Elbow chair and is working with design company Hackrod to create a car."

Investors have recognized the growth potential in the S&P 500 Application Software industry, which has risen 32.6% over the past year through Tuesday's close ([Fig. 8](#)). Revenues over the next year are expected to grow 12.8%, and, as we mentioned above, earnings are forecasted to rise 20.6% ([Fig. 9](#)). That has left the industry's forward P/E at a lofty 35.6—which is in the area where it has traded over the last three years, but higher than any multiple investors had given it in the prior decade ([Fig. 10](#)).

(2) *Hot semis*. It doesn't matter whether a company designs semiconductors or makes the equipment to produce them, anything related to semiconductors has been hot for the past year. Investors are salivating over the increasing number of semiconductors that will be needed to run robots and drones, not to mention autonomous cars. The semiconductor dollar content per smartphone is roughly \$50 vs more than \$350 per car, according to a 4/10 [article](#) on Benzinga.com.

Over the past year, S&P 500 Semiconductor Equipment was the top-performing industry with a gain of 103.8%, driven by the performance of Applied Materials and Lam Research ([Fig. 11](#)). The industry's forward revenue is expected to climb 10.2%, and forward earnings are thought to rise 15.8% ([Fig. 12](#)). As a result, the industry's forward P/E of 15.1 is actually less than its anticipated earnings growth ([Fig. 13](#)).

A 4/23 [WSJ article](#) suggested that these cyclical stocks still had room to run because of a new production process being rolled out. The article explained: "Most different this time is the market for flash memory, which is in the midst of shifting to a new production process called 3D NAND. This has caused a supply shortage that has boosted NAND spot prices by 42% over the past 12 months, according to DRAMeXchange. It also has spurred demand for equipment as memory makers upgrade their fabs. Wes Twigg of Pacific Crest projects that capital expenditures for Flash memory production will jump 25% this year. Atif Malik of Citigroup said he expects the current supply-demand balance to 'remain tight' through 2018, which will likely keep pricing strong through then."

Not far behind is the S&P 500 Semiconductors industry index, up 48.5% y/y, making it the fifth best-performing industry we track ([Fig. 14](#)). The industry's average performance hides the outrageous returns of names like Nvidia, up more than 200%, and Micron Technology, up almost 190%.

Nvidia specializes in graphics chips typically in high-end computers used for gaming. "But they are also well suited to many of the types of tasks required for the machine learning that makes artificial intelligence possible. They can also accelerate the performance of CPUs of the type made by Intel. This gives (Nvidia's chips) a growing role in data centers," stated a 5/16 [WSJ article](#), which explained

how Nvidia invaded Intel's turf. Intel shares are only up 18.4% over the last year.

Semis are expected to grow revenues by 6.5% and earnings by 12.0% over the next 12 months ([Fig. 15](#)). At 14.7, the forward P/E is right in the middle of the 10 to 20 P/E range that the industry has held had for most of the past 10 years ([Fig. 16](#)).

CALENDARS

US. Thurs: Jobless Claims 240k, Leading Indicators 0.3%, Philadelphia Fed Manufacturing Index 19.6, Weekly Consumer Comfort Index, EIA Natural Gas Report. **Fri:** Baker-Hughes Rig Count. (Bloomberg estimates)

Global. Thurs: UK Retail Sales 2.0% y/y, Australia Employment Change & Unemployment Rate 5k/5.9%, Draghi. **Fri:** Eurozone Consumer Confidence -3, Canada CPI 0.5%/m/m/1.7%/y/y, Canada Retail Sales 0.3%. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators ([link](#)): The Investors Intelligence Bull/Bear Ratio (BBR) climbed for the fourth week this week from 2.84 to an 11-week high of 3.40 over the period, though there was not much movement during the latest week. Bullish sentiment edged down to 58.1% this week after rebounding 6.8ppts the prior three weeks to 58.7%; it remains near its 63.1% reading 11 weeks ago—which was the most bulls since 1987! Bearish sentiment slipped for the second week to 17.1% from 17.9% two weeks ago. It has fluctuated in a narrow band since the first week of March, dropping to the bottom of the band the past two weeks. Meanwhile, the correction count climbed for the second week to 24.8% after falling to a nine-week low of 23.6% two weeks ago. The AAll Bull Ratio fell to 52.0% last week after advancing the previous two weeks from 39.9% to 56.0%. Bullish sentiment fell from 38.1% to 32.7%, while bearish sentiment ticked up from 30.0% to 30.2%.

S&P 500 Earnings, Revenues & Valuation ([link](#)): S&P 500 consensus forward revenues edged down w/w from a record high, but forward earnings was at a record high for a sixth straight week. The forward profit margin forecast was also at a record high, but steady w/w at 10.9%. The profit margin's record high is its first since September 2015 and up from a 24-month low of 10.4% in March 2016. Forward revenue growth for the S&P 500 edged down w/w to 5.3% from 5.4%. That compares to 5.8% in late January, which was the highest since May 2012 and up from a seven-month low of 2.7% in late February 2016. Forward earnings growth was steady at a 15-week high of 11.2%, which is down from 11.7% in early January; that was the highest since October 2011 and compares to an 11-month low of 4.8% in February 2016. S&P 500 forward revenues and forward earnings growth are enjoying a tailwind now due to easy y/y comparisons for Energy and improving prospects for Financials, but currency translation is likely to be a slight drag. However, Energy's contribution to forward growth peaked at the start of 2017. Looking at last week's results for the S&P 500 ex-Energy, the forward growth rates for revenues (4.4%) and earnings (8.7%) are lower. The ex-Energy forward profit margin was steady at 11.5%, matching its record high of 11.5% in August 2007. Valuation was unchanged w/w at 17.6, which compares to a 13-year high of 18.0 in early March and a 15-month low of 14.9 in January 2016. Ex-Energy valuation was also steady at 17.2, which is down from a 13-year high of 17.6 in early March.

S&P 500 Sectors Earnings, Revenues & Valuation ([link](#)): Consensus forward revenue forecasts rose last week for 5/11 sectors, and forward earnings rose for 7/11. Consumer Staples and Utilities had both measures rise w/w while these three had both measure decline: Financials, Materials, and Telecom. 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 stalling recently near 15-month highs. Forward P/S ratios rose for all but Health Care and P/E ratios rose for 7/11 sectors. Financials' P/E is up from 12.0 before the election to 13.5, but that's down from a post-election high of 14.6 in early March. Health Care's P/E of 15.7 and P/S of 1.65 are down from early March's 19-month highs of 16.1 and 1.70, respectively, and remain well below their early 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 1.38 compares to a record high of 1.56 in May 2016, and its P/E of 25.8 is down from a record high of 57.5 then. Higher y/y margins occurred for only 7/11 sectors in 2016, and margins are expected to improve in 2017 for all but Real Estate and Utilities. However, Real Estate's forecasted margin should improve as the year progresses when gains on property sales are included in the forecasts. Here's how the 11 sectors rank based on their current 2017 forecasts: Information Technology (to 19.7% in 2017 from 19.2% in 2016), Real Estate (16.6, 25.2), Financials (15.8, 14.4), Telecom (11.3, 11.2), Utilities (10.9, 11.4), S&P 500 (10.6, 10.1), Health Care (10.4, 10.3), Materials (10.0, 9.4), Industrials (9.1, 8.8), Consumer Discretionary (7.3, 7.2), Consumer Staples (6.7, 6.5), and Energy (4.5, 1.1).

GLOBAL ECONOMIC INDICATORS

Eurozone CPI ([link](#)): April's CPI rate climbed to 1.9% y/y, matching the flash estimate, bouncing back to a level in line with the ECB goal. In March, the rate slowed to 1.5% after accelerating 2.0% in February—surpassing the inflation target of just under 2.0% for the first time in four years. Meanwhile, the core inflation rate—which excludes food, alcohol & tobacco—was the highest in almost four years, climbing 1.2% y/y from 0.7% in March, which was near its record low of 0.6% in spring 2015. Of the main components, energy (to 7.6% from 7.4% y/y) and services (1.8 from 1.0) costs accelerated, while food, alcohol & tobacco (1.5 from 1.8) slowed; the gain in non-energy industrial goods prices was unchanged at 0.3% y/y. Of the top four Eurozone economies, inflation rates in Spain (2.6% y/y), Germany (2.0), and Italy (2.0) were above the Eurozone's 1.9%, while France's (1.4) was below. The lowest rates were recorded in Ireland (0.7) and Slovakia (0.8), the highest in Estonia (3.6), Lithuania (3.5), and Latvia (3.3).

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