



MORNING BRIEFING

June 20, 2017

Second Thoughts

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

(1) Dealmakers sinking in the swamp. (2) Animal spirits remain mostly aroused. (3) Back to new normal real GDP growth. (4) Cruising along at 2%. (5) Citigroup Economic Surprise Index fluctuates. (6) Housing starts depressed by fewer DIYs. (7) Not-so-bad retail sales and production indicators. (8) Looking up in NY and Philly districts. (9) Record highs for forward revenues and earnings. (10) It all adds up to our No-Boom-No-Bust scenario, which remains bullish for stocks.

US Economy: Animals Dispirited? Following Election Day, there was a widespread jump in consumer and business confidence. It was widely deemed that this reflected the unleashing of “animal spirits” when Donald Trump won with majorities in both houses of Congress. Suddenly, his campaign promises, which included tax cuts for individuals and businesses, seemed quite doable. So did his plan to repatriate \$2.5 trillion of corporate cash stashed overseas, as well as his commitment to slash business regulations. Debbie and I argued that, perhaps most significantly, the election marked a remarkable regime change. Over the past eight years, we’ve had government by community organizers, who were mostly lawyers with lots of government experience but almost no business experience. Trump and his Cabinet are dealmakers with lots of business experience but very little government experience.

A 1/5 *FT* article by Gillian Tett titled “Donald Trump unleashes business’s animal spirits” reported that Trump’s top eight officials (president, vice-president, chief of staff, attorney-general, and secretaries of State, Commerce, Defense, and Treasury) had only 55 years of government experience but 83 years in business. Obama’s comparable team had 117 years in government, but ONLY five years in business IN TOTAL.

Debbie and I argued that some of the aroused animal spirits might be reflecting the regime change, with many of the optimists excited about simply having a very pro-business administration. If so, then actually implementing the full Trump economic agenda might not be crucially important for sustaining animal spirits. After all, the economy is at full employment, and more economic stimulus is not an urgent priority. The stock market has been moving into record-high territory since July 11, 2016. The Fed started to normalize monetary policy by raising the federal funds rate in late 2015 at a gradual pace. Fiscal stimulus would most likely be offset by a more aggressive normalization of monetary policy.

So here we are with an administration full of dealmakers and very few deals to show for it so far. Perhaps some are in the works. Trump also promised to “drain the swamp.” So far, it looks like the swamp is deeper than he thought, and he seems to be sinking in it. In any event, animal spirits mostly remain elevated, as evidenced by the latest “soft data” that we continue to monitor in our [Animal Spirits](#) chart book. However, the hard economic data remain relatively soft. Consider the following:

(1) *Real GDP*. After Trump’s election, Debbie and I raised our real GDP forecast for this year from 2.5% to 3.0%. That’s on a Q4-to-Q4 basis. Now we are lowering it to 2.1%. It’s been growing around 2.0% since Q2-2010 ([Fig. 1](#)). Even during Q1-2017, which was up just 1.2% (q/q saar), it rose 2.0% y/y! If it

continues to do so, that would imply q/q growth rates for Q2-Q4 of 1.8%, 3.5%, and 2.1% ([Fig. 2](#)).

Previously, we've observed that from H2-2010 to H1-2015, real GDP was growing around 3.0% excluding spending by federal, state, and local governments ([Fig. 3](#)). Government spending in real GDP is on goods and services, not on entitlement programs, which redistribute income. These programs may now be so large that they are putting a lid on government spending on goods and services, which certainly explains the awful condition of infrastructure in the US. In any case, the weakness in government spending in real GDP has been an unusual drag on the current expansion ([Fig. 4](#)). The good news is that it turned positive on a y/y basis from Q4 2014 through Q4-2016, though it was down again during Q1-2017 by a modest 0.5%. The bad news is that excluding government, real GDP growth seems to have slowed from 3.0% closer to 2.0% since mid-2015.

By the way, on Friday, the Atlanta Fed's [GDPNow](#) reported: "The GDPNow model forecast for real GDP growth (seasonally adjusted annual rate) in the second quarter of 2017 is 2.9 percent on June 16, down from 3.2 percent on June 14. The forecast for second-quarter real residential investment growth decreased from 1.8 percent to 0.4 percent after this morning's housing starts release from the U.S. Census Bureau. The forecast of the contribution of net exports to second-quarter growth declined from -0.23 percentage points to -0.34 percentage points after yesterday's Import/Export Price Index release from the U.S. Bureau of Labor Statistics."

(2) *Economic surprise index*. Among the softest of the hard data indicators is the Citibank Economic Surprise Index ([Fig. 5](#)). It continued to plunge last week, falling from a recent high of 57.9 on March 15, 2017 to -78.6 last Friday. That's the lowest since August 19, 2011. The good news is that this is a highly cyclical series with lots of short-term swings. In the past, when it has dropped this much this fast, it has tended to rebound strongly.

For now, it is showing that expectations that the rebound in animal spirits would boost the actual economy haven't been realized. As expectations turn more moderate, they are more likely to be realized or exceeded.

(3) *Housing starts*. As Debbie discusses below, housing permits and starts have been weaker than expected recently for both single-family and multi-family units ([Fig. 6](#)). Single-family housing starts remain on an upward trend. However, so far, they have recovered only to previous cyclical lows.

Contributing to the slow housing recovery is that fewer individuals than ever before are building their own homes. We can track the do-it-yourself trend by monitoring the difference between new single-family home completions and new single-family home sales ([Fig. 7](#)). The 12-month moving sum of this volatile series has remained below 200,000 since the start of the current recovery. That's the lowest pace on the record, which starts in 1968!

(4) *Retail sales & production*. The good news is that the recent spate of bad news wasn't so bad. While retail sales fell 0.3% m/m during May, the three-month change in the three-month average of inflation-adjusted retail sales was 3.9% (saar), the best pace since September 2016 ([Fig. 8](#)). Industrial production was unchanged during May, yet the three-month change in the three-month average was 3.8% (saar), the best since July 2014! This augurs well for a pickup in real GDP growth during the current quarter.

(5) *Animated animal spirits*. Meanwhile, animal spirits haven't retreated much even though Trump seems to be thrashing about in Washington's swamp waters. The latest reading we have on business conditions comes from the June district surveys conducted by the Federal Reserve Banks of NY and Philly. The average of their general business conditions indexes rose to 23.7 during June, up from 18.9

last month ([Fig. 9](#)).

The Business Round Table reports that the CEO Economic Outlook Index was 93.9 during Q2, exceeding Q1's 93.3 reading, with both well above Q4's 74.2 tally ([Fig. 10](#)). That augurs well for capital spending.

(6) *Forward revenues & earnings*. Debbie and I are big fans of the soft data that Thomson Reuters I/B/E/S compiles of forward revenues and forward earnings for the S&P 500 ([Fig. 11](#)). These series are time-weighted averages of industry analysts' consensus forecasts for the current year and the coming year. Both tend to be very good leading indicators for S&P 500 revenues and earnings. They are highly correlated with numerous business-cycle indicators. Their only flaw is that they don't see recessions coming. However, if there isn't likely to be one over the next 52 weeks, then they are signaling that the economy continues to expand into record-high territory.

(7) *Bonds & stocks*. Finally, we need to consider the mixed message coming out of the bond and stock markets. The recent decline in bond yields and narrowing of the yield curve spread suggest weaker economic growth. That doesn't seem to be fazing the stock market, which continues to make new record highs.

Our interpretation is that they are both consistent with our NBx2 scenario for the economy, i.e., No Boom, No Bust. In this scenario, inflation is likely to remain subdued. If so, there might be only three more 25bps hikes in the federal funds rate, to 2.0% by the end of next year, then that might be it for a while.

CALENDARS

US. Tues: Current Account Balance -\$121.8b, Fischer, Kaplan. **Wed:** Existing Home Sales 5.55mu, MBA Mortgage Applications, EIA Petroleum Status. (Bloomberg estimates)

Global. Tues: RBA June Meeting Minutes, Carney, Zhou Xiaochuan. **Wed:** Japan Machine Tool Orders, Kuroda. (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—continues to hover around its record high, retreating 1.8% over the three weeks ending June 10 after a two-week jump of 2.3% 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 contracted 2.7% over the three-week period, following a two-week surge of 3.3%, also to a new record high, as jobless claims rose for the third week to 243,000 (4-wa) from 235,500 three weeks ago, which was the lowest since April 1973. The CRB raw industrial spot price index—another BBB component—fell but has stabilized in recent sessions. Meanwhile, the WCCI ticked up 0.2% after slumping 2.5% the prior week and climbing 3.0% the previous three weeks.

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings rose last week to record highs for all three market-cap indexes. 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 improved to 9.8% y/y from 9.6%, which compares to a 64-month high of 10.2% six weeks ago and a six-year low of -1.8% in October 2015; MidCap's was up to 12.5% from 12.3%, which compares to a 32-month high of 12.6% and a six-year low of -1.3% in December 2015; and SmallCap's rose to 12.0% from 11.1%, which compares to a 34-month high of 12.8% in mid-March and a six-year low of 0.3% in

December 2015. Consensus growth rates now expected for 2017 and 2018 before the impact of tax-rate changes: LargeCap 11.6% and 11.8%, MidCap 11.3% and 13.6%, and SmallCap 9.3% and 19.4%.

S&P 500/400/600 Forward Valuation ([link](#)): Forward P/E ratios were lower for the three indexes last week. Valuations have improved from their more-than-five-month lows in mid-April, but remain below their multi-year highs in early March. P/Es have melted up since the election, but the “E” still remains low as analysts await legislative changes to the tax rate and its impact on corporate earnings. LargeCap’s forward P/E edged down w/w to 17.5 from 17.6 and is down from early June’s 11-week high of 17.7, but remains near the 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 18.2 from 18.3, which compares to a 15-year high of 19.2 in late February and the record high of 20.6 in January 2002. MidCap’s is up from a three-year low of 15.0 in January 2016. SmallCap’s fell to 19.3 from a 10-week high of 19.7, which compares to a 15-year high of 20.5 in early December, when Energy’s earnings were depressed. That’s up from a three-year low of 15.5 in February 2016 and remains close to SmallCap’s record-high P/E 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 1.95 is at a record high, while MidCap’s 1.29 is close to its record high of 1.37 in late February. SmallCap’s 1.00 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](#)): Q2 earnings estimates were reduced somewhat by analysts last week as they performed their typical downward pre-earnings season adjustments. The Q2 consensus fell w/w for seven of the 11 S&P 500 sectors, rose for one, and was steady for the remaining three. Tech rose 0.2% w/w, and these three were steady: Industrials, Telecom, and Utilities. Sectors with the biggest w/w decline in their Q2 forecast: Energy (-1.1%), Materials (-0.8), Real Estate (-0.8), and Financials (-0.6). The S&P 500’s Q2-2017 EPS forecast fell 2 cents w/w to \$31.44, but is down just 2.0% from \$32.04 at the end of Q1. That represents a forecasted pro forma earnings gain for Q2-2017 of 8.1% y/y, down from Q1’s blended 15.5%, which is the strongest growth since Q3-2011 owing mostly to easier comps for Energy. The Q2-2017 forecast is down from 8.2% a week earlier and 11.9% at the end of Q4. Since the end of Q1, Q2 estimates are lower for ten sectors and higher for one. Industrials’ Q2 forecast has risen 0.6%. Energy has dropped 10.5% for the worst decline, followed by Materials (-5.0), Telecom (-4.4), Consumer Discretionary (-3.8), and Tech (-3.3). The S&P 500’s Q2-2017 forecasted earnings gain of 8.1% y/y would be its fourth straight gain after four declines. Ten of the 11 sectors are expected to record positive y/y earnings growth in Q2-2017, but only three are expected to beat the S&P 500’s forecasted y/y earnings gain of 8.1%. That’s because analysts expect Energy to report a large profit jump in Q2 relative to very low earnings a year ago. Still, that matches the 10/11 sectors that rose y/y on a blended basis during Q1-2017. The latest forecasted Q2-2017 earnings growth rates vs their blended Q1-2017 growth rates: Energy (692.2% in Q2 vs a return to a profit in Q1), Tech (11.0% vs. 20.9%), Financials (8.6, 19.9), S&P 500 (8.1, 15.5), Materials (4.2, 19.3), Consumer Staples (3.2, 3.6), Health Care (2.3, 7.3), Real Estate (1.9, 2.8), Industrials (1.8, 4.1), Telecom (1.2, -4.9), Consumer Discretionary (0.7, 6.4), and Utilities (-3.2, 2.7).

US ECONOMIC INDICATORS

Housing Starts & Building Permits ([link](#)): Housing starts in May sank for the third month, to an eight-month low. Builders broke ground on 1.092mu (saar)—the lowest since September, falling 5.5% m/m and 16.0% over the three-month period. Single-family starts slumped by 3.9% and 9.5% over the comparable periods to 794,000 units (saar), while multi-family starts dropped for the fifth straight month, plunging 9.7% m/m and 35.2% ytd to 298,000 units; both were at eight-month lows. Building permits have declined in three of the past four months, to a 10-month low of 1.168mu (saar), falling 4.9% in May and 10.2% over the period, with multi-family permits 21.2% lower since January to 389,000 units.

Single-family permits declined for the fourth time in five months, down 1.9% m/m and 6.1% ytd to 779,000 units (saar). Meanwhile, June's NAHB's Housing Market Index shows that all three components posted losses in June but remain at healthy levels. The components gauging current sales conditions (to 73 from 75), sales expectations in the next six months (76 from 78), and buyer traffic (49 from 51) all fell 2 points. NAHB's chief economist notes, "As the housing market strengthens and more buyers enter the market, builders continue to express their frustration over an ongoing shortage of skilled labor and buildable lots that is impeding stronger growth in the single-family sector."

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