MORNING BRIEFING
June 22, 2017

Sheik Up

See the collection of the individual charts linked below.

(1) Opaque oil: Hard to see higher prices. (2) S&P 500 Energy is dead last so far this year. (3) US, Libya, and Nigeria are offsetting OPEC's production cuts. (4) Tanks and tankers filled to the brim with crude. (5) Saudis give more power to a young sheik. (6) Saudi Vision 2030 plan aims to diversify economy away from oil. (7) Oil weighs less on S&P 500. (8) Saudis selling the family's jewel. (9) Cheers for S&P 500 Restaurants.

Energy: Crude Reality. Oil investors don't like what they see: too much supply and not enough demand. They don't like the growing number of barrels being produced in America, Libya, and Nigeria. Nor are they comforted by the sluggish growth in demand caused by the lackluster pace of global economic activity, increased energy efficiency, and alternative fuels. This one-two-three punch has sent the price of Brent crude oil into its latest bear market, down 21% to $44.92 as of yesterday's close (*Fig. 1*).

Energy is the worst-performing S&P 500 sector ytd, down 13.5%, and many of the sector's industries are doing even more poorly: Oil & Gas Drilling has lost 36.4% ytd, Oil & Gas Exploration & Production has lost 20.5%, and Oil & Gas Equipment & Services is down 19.3% (*Fig. 2* and *Fig. 3*).

Most other S&P 500 sectors have been enjoying much better ytd performances through Tuesday's close: Tech (18.2%), Health Care (14.4), Utilities (11.0), Consumer Discretionary (10.3), Materials (9.0), Industrials (8.9), S&P 500 (8.9), Consumer Staples (8.8), Real Estate (5.5), Financials (4.6), Telecom Services (-10.5), and Energy (-13.5) (*Table*). Let's take a look at the push and pulls affecting the price of black gold:

(1) *The US is pumping.* In Q1, the amount of oil being produced and the amount of oil being consumed weren't that far out of whack. Total world demand was 96.5 mbd in Q1, and total supply was 96.6 mbd, according to the International Energy Agency's (IEA) 5/16 Oil Market Report. That's a significant improvement from Q4-2016, when demand was 97.7 mbd and supply was 98.3 mbd. OPEC's production cut of about 1.8 mbd, which began last year and is expected to continue through March 2018, looked like it was balancing the market until recently.

However, continued supply growth out of the US and production rebounds in Libya and Nigeria subsequently have overshadowed OPEC cuts. US crude production hit 9.35 mbd after rising by 20,000 barrels during the week of June 16. As a result, production is not far from the peak amount produced during the week of June 5, 2015, 9.6 mbd (*Fig. 4*). Production never fell as dramatically as the US oil rig count, as producers managed to coax more oil out of existing wells. And after bottoming in late May 2016 at 316, the number of US rigs has increased to 747 (*Fig. 5*).

Those rigs have been awfully busy. At the end of May, there were 5,946 drilled-but-uncompleted wells, the most in at least three years, according to estimates by the US Energy Information Administration (EIA). "In the last month alone, explorers drilled 125 more wells in the Permian Basin than they would open, meaning production could surge when they turn on the spigots," a 6/19 Bloomberg article reported.

The US isn't the only country increasing production. Libya is producing 902,000 bpd, up about 200,000 barrels since April because two fields returned to production. It's the most the country has produced since 2013, when production hit 1.13 million bpd, another 6/19 Bloomberg article reported. Libya is exempted from the OPEC production cuts.

(2) *Brimming inventories*. Excess production has kept US inventories stubbornly high. For the week ending June 16, US crude oil inventories (excluding those in the Strategic Petroleum Reserve) decreased by 2.5 million barrels to 509.1 million barrels, according to yesterday's EIA report. That still leaves inventories slightly above where they stood last year, at 500.0 million barrels, and far above where they stood in the three years prior to that (*Fig. 6*).

High inventories in other countries around the world are prompting oil traders to store increasing amounts of oil at sea. "The amount of oil stored in tankers reached a 2017 high of 111.9 million barrels earlier this month, according to Paris-based tracking company Kpler SAS. Higher volumes of storage in the North Sea, Singapore and Iran account for most of the increase," yet another 6/19 Bloomberg article reported. "As recently as May 1, the average volume was about 74 million barrels, according to Kpler."

(3) *Sluggish demand.* Global demand growth for oil in Q1 was only 0.9 mbd, according to an IEA report. However, the agency expects demand to pick up in the second half of the year, bringing full-year demand growth to 1.3 mbd in 2017 and 1.4 mbd in 2018, as worldwide demand reaches a record of 99.3 mbd.

Those projections may be tough to hit if the recent drop in demand for gasoline doesn't go into reverse. Gasoline usage has dropped to 9.23 mbd during the week of June 16 from a peak of 9.37 mbd last fall. The drop in gasoline usage is of note because the number of vehicle miles traveled has continued to climb to record highs (*Fig. 7*). It could have much to do with the improved fuel efficiency of US cars. By our calculation, the average miles per gallon is 22.4, near the record hit in October 2013 when gas prices were much higher and there was more demand for smaller cars (*Fig. 8*).

The number of electric vehicles on the road also bears watching, as it may be affecting demand on the margin. For the year ending November 2016, more than 130,000 hybrid or battery-powered vehicles were sold in the US, almost double the 73,000 vehicles sold in 2012, notes a 12/21 Recode article. That's still far from the average 17 million total cars sold in each of the past three years in the US. But the number may be about to jump once again, as Tesla's $35,000 Model 3 is expected to hit the market this year.

(4) *Prince of Arabia & Vision 2030.* According to *Time*: "Undoing decades of royal tradition, Saudi Arabia's King Salman appointed his 31-year-old son Mohammed Bin Salman to be next in line for the throne on Wednesday, signaling a historic political shift in one of the Middle East's key regional powers.

"A rising star within the Saudi royal family, Mohammed Bin Salman was already one of the kingdom's most powerful leaders. He advocates a forceful Saudi foreign policy and is also leading a massive overhaul of the Saudi economy. As the country's defense minister, he is in charge of Saudi Arabia's two-year-old air war in Yemen, where more than 10,000 people have died in one of the world's most dire humanitarian crises."

In 2016, the prince-in-waiting implemented Vision 2030, a plan to restructure the economy away from its dependence on oil exports. It states: "Diversifying our economy is vital for its sustainability." On

Monday, we advised OPEC countries with large oil reserves as follows: "Rather than propping up the price, maybe OPEC should sell as much of their oil as they can at lower prices to slow down the pace of technological innovation that may eventually put them out of business." That's so obvious that a smart young man like Mohammed Bin Salman probably gets it.

(5) *Less influence.* The S&P 500's ability to remain near record levels given the selloff in the Energy sector is reasonable—so far. The S&P 500 Energy sector's market weighting in the S&P 500 has shrunk to 6.0% from its peak of 16.1% in July 2008. Likewise, the amount of earnings it contributes to the broader index is now 4.3%, down from 21.3% then (*Fig. 9*). So while crude has entered a bear market, its influence on the broader index has fallen as the S&P 500 has continued to hit new highs, Bloomberg rightly noted on 6/20.

The question will be whether the oil bear market will lead many energy companies to shut down production if drilling becomes uneconomic at these lower prices. A 6/19 *WSJ* article said many shale producers had lowered their production costs so that they could be profitable when oil fetched $50 to $60 a barrel, and a handful could even turn a profit if the price fell to $40. That certainly isn't good news for the upcoming Saudi Aramco IPO. Saudi Arabia's ruling family undoubtedly is watching. There is usually an obvious reason for selling the family jewels.

Restaurants: Tech on Tap. In our 3/24 *Morning Briefing* last year, we took a trip down Memory Lane and wrote about Horn & Hardart's Automat, where in the early 1900s, customers could find their prepared meal behind small glass windows and buy it for under $1 by placing coins in a slot. Today, many restaurants are taking a page out of the Automat's playbook, often in an effort to reduce labor costs.

We mentioned Eatsa, a California eatery where customers order on an iPad, then visit a wall to retrieve their meal. Panera Bread and McDonald's have been rolling out kiosks where customers can order and pay, avoiding the line—and the human—at the register. Jackie reports that her local TCBY has a wall of soft-ice-cream dispensers that lets customers take as much ice cream as they can fit into oversized cups. It's a disastrous format for dieters but brilliant for business, she notes.

Now there's a new twist on wall dispensers for the 21-and-over crowd. Instead of a wall of soft-serve ice cream, Randolph Beer in Brooklyn is offering a wall of beer taps. Customers hand over a credit card and receive an ATM card that can activate 24 self-service taps, according to a 6/9 article in Metro, brought to our attention by ZeroHedge. A screen over each tap displays the beer's name, brewer, and country of origin as well as notes on how the beer tastes.

Randolph Beer hasn't abandoned the "Cheers" model altogether; however, its traditional bar and bartender can only serve one customer at a time, not 24. A "Norm" might not like the change, but the easily accessible taps mean that Randolph Beer can serve many more beverages during Happy Hour without having to hire another "Sam."

The S&P Restaurant index, up 17.9% ytd as of Tuesday's close, has risen twice as much as the S&P 500 (*Fig. 10*). Much good news is priced into the industry, which sports a forward P/E of 24.4, close to the highest P/E the industry sported in 2015 and 2016, 25.3, and not far from its highest P/E ever, 28.5 in April 1999 (*Fig. 11*).

CALENDARS

US. Thurs: Leading Indicators 0.3%, Jobless Claims 240k, Kansas City Manufacturing Index, FHFA House Price Index 0.5%, Weekly Consumer Comfort Index, EIA Natural Gas Report, Powell. **Fri:** New

Home Sales 590k, C-PMI, M-PMI & NM-PMI Flash Estimates 53.8/52.7/53.7, Baker-Hughes Rig Count, Dudley, Powell. (Bloomberg estimates)

Global. Thurs: Eurozone Consumer Confidence -3, Canada Retail Sales Headline and Ex Autos 0.3%/0.7%, ECB Publishes Economic Bulletin. **Fri:** Eurozone, Germany, and France C-PMI Flash Estimates 56.6/57.2/56.7, Eurozone, Germany, and France M-PMI Flash Estimates 56.8/59.0/54.0, Eurozone, Germany, and France NM-PMI Flash Estimates 56.1/55.4/57.0, Japan M-PMI Flash Estimates, Canada CPI 1.5% y/y. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): The Investors Intelligence Bull/Bear Ratio (BBR) sank back further below 3.00 this week, falling from 3.05 to 2.65 the past two weeks—near its low for the year of 2.60 recorded three weeks ago. Bullish sentiment climbed 1.5ppt this week to 51.5% after dropping 5.8ppts to 50.0% last week, which was near its low for the year of 49.5%. Bearish sentiment moved up from 18.3% to 19.4% the past two weeks—a new high for this year. The correction count fell to 29.1% after rising from 25.9% to 31.4% last week, which was just a percentage point below its high for the year recorded in late March. The AAII Ratio slipped to 52.3% last week after climbing from 46.0% to 54.5% the previous week. Bullish sentiment fell from 35.4% to 32.3%, while bearish sentiment was unchanged at 29.5%.

AC World ex-US MSCI (*link*): This index is up 12.3% ytd in dollar terms after rising 1.7% in 2016. In local-currency terms, the index has risen a lower 8.3% ytd compared to its 4.1% gain for all of 2016. Local-currency forward revenues has risen 6.0% from a five-year low in March 2016 to its highest level since November 2015, but has been more stable longer term and is down just 4.9% from its October 2014 record high. Local-currency forward earnings has performed better, with a 15.0% rise from its six-year low in March 2016 to its highest level since November 2008, but remains 9.4% below its September 2008 record. Revenues are expected to rise 7.3% in 2017 and 4.8% in 2018 following a 0.9% decline in 2016, and earnings are expected to rise 18.2% (2017) and 9.3% (2018) after rising 1.7% (2016). Analysts are forecasting STRG of 6.2%, down from a seven-year high of 6.8% in March and up from a cyclical low of 2.3% in March 2016. Their STEG forecast of 13.2% is down from a four-year high of 14.1% in March, but up from their 6.3% forecast in January 2016, which was the lowest in seven years. The implied profit margin is expected to rise to 7.6% in 2017 from 6.9% in 2016 before improving to 7.9% in 2018. NERI was positive for a sixth month in June and for the first time since March 2011, but slipped to 1.7% from a 76-month high of 2.7% in May. That compares to a 51-month low of -11.3% in March 2016. The P/E fell to 14.2 from a 22-month high of 14.4 in May, which compares to a 16-month low of 12.4 in February 2016 and a six-year high of 15.3 in April 2015. The index's 11% discount to the World P/E has improved from a record-low 13% discount in early March.

EMU MSCI (*link*): The EMU's MSCI price index has gained 16.2% ytd in dollar terms after falling 1.2% in 2016. In euro terms, the price index is up a lower 10.2% ytd following a 1.8% gain for all of 2016. Euro-based forward revenues has improved 3.2% from its six-year low in May 2016, but remains 1.0% below its cyclical high (August 2015) and 7.7% from its record high (September 2008). Euro-based forward earnings had stalled since 2011—but is now 5.4% above its prior cyclical high in September 2015 to its highest level since October 2011. It remains 24.0% below its record high (January 2008), but has improved 12.7% from its 23-month low in June 2016. Analysts expect revenues to rise 5.0% and 3.7% in 2017 and 2018, respectively, after falling 1.9% in 2016, but think earnings will rise 22.4% in 2017 and 9.5% in 2018 following a 5.5% decline in 2016. Forecasted STRG of 4.9% is at a six-year high and up from 2.0% in May 2016. Forecasted STEG of 15.4% is down from 17.1% in May and from a 78-month high of 21.0% in February, which compares to a seven-year low of 5.7% in April 2016. STEG has been higher than LTEG (12.6%) since July 2016 after trailing it since late 2015. The forward profit margin has improved 1.6ppts to a six-year high of 7.3% from a cyclical bottom of 6.2% in May 2013. The implied profit margin is expected to improve to 7.1% in 2017 from 6.1% in 2016 before rising another 0.4ppt to 7.5% in 2018. NERI was positive for a seventh straight month in June, but edged down 0.5ppt m/m to 7.6% from a 131-month high of 8.1% in May, which compares to a 24-month low of -13.2% in April 2016. The P/E of 14.7 is down from 15.0 in May and from a 13-year high of 16.4 in April 2015, but up from a 30-month low of 12.2 in February 2016. That represents an 8% discount to the World MSCI's P/E now, up from a record-low 25% discount during 2011. But the current reading is still well below the 1% premium during April 2015—the post-euro-inception record high.

Emerging Markets MSCI (*link*): The EM MSCI price index is up 17.0% ytd in US dollar terms after rising 8.6% in 2016. In local-currency terms, EM has gained a lower 13.3% ytd compared to a 7.1% gain in 2016. Local-currency forward revenues is up 4.2% from a four-year low in June 2016 to 12.3% below its November 2014 record. Local-currency forward earnings has fared substantially better, improving 19.0% from April 2016's six-year low and is down just 2.7% from its January 2014 record. Revenues are expected to rise 10.2% in 2017 and 8.1% in 2018 following a 2.4% gain in 2016, leading to earnings gains of 20.4% (2017) and 11.4% (2018) following a 7.8% rise in 2016. Forecasted STRG of 9.4% is back on an uptrend since early 2016, but is down slightly from a four-year high of 9.6% in late January. STEG of 16.0% is near a six-year high, but is below LTEG (17.4%) again. The implied profit margin is expected to improve to 6.8% in 2017 from 6.3% last year before edging up to 7.0% in 2018. The forward profit margin of 7.0% is the highest since February 2013 and up from a record low of 6.0% in February 2016, but remains more than 3ppts below its 10.3% record high in December 2007. NERI—negative for 76 months—ticked down m/m to -1.0% from a 75-month high of -0.6% in May, which compares to an 83-month low of -10.2% in March 2016. Emerging Markets' valuation has been more stable recently than that of the rest of the world. The P/E was down to 12.1 in June from a seven-month high of 12.3 in May, which compares to a 17-month low of 10.2 in August 2015 and a four-year high of 12.6 in April 2015. The index is trading at a 24% discount to the World MSCI P/E, up from a 10-year-low 30% discount in August 2016.

MSCI Countries Net Earnings Revisions (*link*): NERI was positive for 29/44 MSCI countries in June, the most since June 2010 and up from 27/44 in May. NERI improved m/m in June for 18/44 countries, down from 32/44 in May, which was the most since June 2016. Turkey's NERI was at a record high in June, followed by those of France (83-month high), Germany (81), Finland (77), Koreas (77), Chile (71), Malaysia (61), and the Philippines (36). On the flip side, South Africa's was at a 94-month low, followed by those of Egypt (17), Peru (14), Russia (14), Taiwan (11), and the United Kingdom (11). The 15-month positive NERI streak for Hungary is the best, followed by those of Austria (13), Germany (9), Hong Kong (8), Poland (8), and Turkey (8). Brazil's NERI has been negative for 84 straight months, followed by the negative streaks of South Africa (37), India (32), and New Zealand (13). NERI turned positive in June for four countries: Chile (first time in 71 months), Czech Republic (6), Greece (6), and the Philippines 36). NERI turned negative in June for the first time in 14 months for Peru and in 11 months for the United Kingdom. Hungary's NERI has been the strongest recently, with positive readings in 25 of the past 26 months.

US ECONOMIC INDICATORS

Existing Home Sales (*link*): "Those able to close on a home last month are probably feeling both happy and relieved. Listings in the affordable price range are scarce, homes are coming off the market at an extremely fast pace and the prevalence of multiple offers in some markets are pushing prices higher," according to NAR's chief economist. Existing home sales—tabulated when a purchase contract closes—rebounded in May, though supply continued to fall short of demand, propelling the median sales price to a new high. Sales advanced for the second time in three months, up 1.1% last month and 2.7% over the period to 5.62mu (saar). Single-family home sales rose 1.0% and 2.3% over the comparable periods to 4.98mu (saar)—remaining volatile around cyclical highs—while multi-family sales were up 1.6% and 6.7%, respectively, to 640,000 units. Regionally, only the Midwest (-5.9% m/m, -0.8% y/y) saw sales decline on both a monthly and yearly basis in May; the remaining regions showed the following gains: Northeast (6.8, 2.6), the West (3.4, 3.4), and the South (2.2, 4.5). While the number of existing single-family homes on the market rose for the fifth month—from 1.45mu in December to 1.74mu in May—they were still 7.9% lower than a year ago, and have recorded y/y declines for 24 consecutive months. Unsold inventory was at a low 4.2 months' supply.

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