



## MORNING BRIEFING

July 27, 2017

### Shovel-Ready Industrials

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

(1) Tale of two industrial companies. (2) Purchasing managers are purchasing. (3) Good vibes from the commodity pits and the forex markets for Industrials. (4) Low-octane fuel. (5) Cat is a tiger. (6) Boeing is flying high. (7) Not much drive among auto manufacturers.

**Industrials I: Digging Most of Them.** In recent days, General Electric and Caterpillar reported earnings. Both companies are in the S&P 500 Industrials sector, and both have operations spanning the earth. But their results—and the response of their respective shares—couldn't have been more different.

General Electric shares slumped 2.9% from Thursday's close to Friday's close after investors learned that the company's fiscal 2017 earnings would come in at the low end of a range given earlier this year. Conversely, Caterpillar shares rallied 5.9% after the company increased both its revenue and its earnings guidance. GE suffered from its exposure to the oil and gas industry and the gas turbine market. Caterpillar benefitted from its exposure to the construction of housing and buildings, mining, and the fracking industry.

GE is such a large company that its underperformance this year—its stock is down 19.5% ytd—is overshadowing the strong performance of other industrial companies. The S&P 500 Industrials stock price index is up 8.7% ytd through Tuesday's close, which means it's lagging behind the S&P 500, which is up 10.6% over the same period. Without GE, however, the S&P 500 Industrials stock price index would be up roughly 13.0%, according to Joe's calculations. It would be outperforming the S&P 500 and would be the third-best-performing sector.

Here's the performance derby of the S&P 500's sectors ytd through Tuesday's close: Tech (22.9%), Health Care (16.6), Consumer Discretionary (12.3), Materials (12.0), S&P 500 (10.6), Industrials (8.7), Financials (8.2), Utilities (8.0), Consumer Staples (7.1), Real Estate (5.3), Energy (-12.7), and Telecom Services (-15.3) ([Fig. 1](#)).

An outperforming Industrials sector makes more sense given some of the strong economic data that has rolled in. Consider the following:

(1) *Managers purchasing.* The US and global M-PMIs have been solid this year. The US M-PMI, at 57.8 in June, has been north of 50.0 since last September. Likewise, the new orders component of M-PMI stands at 63.5, and the employment category clocks in at 57.2 ([Fig. 2](#)). The indicator is also throwing off positive readings around the world. In advanced economies the M-PMI was 53.9 last month, and in emerging economies it was 50.8, the latter indicating economies that were growing but just barely ([Fig. 3](#)).

(2) *Commodity strength.* The prices of most industrial commodities are signaling that all's fine in the world of manufacturing. The CRB raw industrials spot price index is up 2.3% ytd through Tuesday's

close and 27.0% from its 2015 cyclical low ([Fig. 4](#)). The price of copper is up 14.3% since May 8 ([Fig. 5](#)). Even agricultural commodities look like they're bottoming after falling sharply since 2013 ([Fig. 6](#)).

(3) *Oil slick*. There are certainly things to worry about, including the recent drop in the price of oil. A barrel of Brent crude oil recently topped out at \$57.10 on January 6 and has since fallen to \$44.92. However, the decline isn't anywhere near the magnitude of the drop experienced from 2014 through early 2016, when a barrel of crude fell from \$115.06 to \$27.88, sending the industrial sector into a mini-recession ([Fig. 7](#)).

(4) *Dollar tailwind*. Looking ahead, Industrials stands to benefit if the recent decline in the dollar holds. The dollar, which rallied since the summer of 2014, continued to do so in the wake of the US presidential election last year and peaked on January 11 at 126.21, falling 7.2% since then to 117.10 ([Fig. 8](#)). If the dollar is flat for the remainder of the year, S&P 500 earnings growth will get a 4ppt earnings bump, according to a 7/25 Bloomberg [article](#) citing Morgan Stanley estimates.

**Industrials II: Winners & Losers.** A number of industries within the S&P 500 Industrials sector are generating very different returns this year. Some of the winners ytd through Tuesday's close include: Construction Machinery & Heavy Trucks (19.7%), Aerospace & Defense (19.5), Industrial Machinery (14.9), and Electrical Components & Equipment (13.5) ([Fig. 9](#)). Meanwhile, some industries that have underperformed ytd include: Industrial Conglomerates (-4.1), Trucking (-4.5), Air Freight & Logistics (4.2), and Airlines (6.3) ([Fig. 10](#)).

Overall, the Industrials sector is expected to produce 4.1% revenue growth over the next 12 months and earnings growth of 10.1% over the same period. The fastest-growing industries in the sector include: Construction & Farm Machinery, with forward earnings expected to grow 17.2%, Diversified Support Services (16.7%), Agricultural & Farm Machinery (15.8), Construction & Engineering (14.6), and Railroads (14.6).

Some of the slowest earnings growth over the next year is expected to come from Human Resources & Employment Services (5.1%), Trading Companies & Distributors (6.9), Airlines (7.6), Building Products (8.0) Air Freight & Couriers (8.1), and Environmental & Facilities Services (8.1). Industrial Conglomerates clocks in at 9.8% earnings growth over the next 12 months.

Here's a look at recent news from Industrials companies and what it may imply about the industries in which they reside:

(1) *Caterpillar*. Caterpillar's Q2 sales rose 10.0% y/y, and operating profit soared 59.4%. The company credited strong results to construction in China and gas compression in North America. In addition, mining and oil-related activities have "come off recent lows, and we're seeing improving demand for construction in most regions," said CEO James Umpleby in the company's Q2 earnings conference call [transcript](#). Just imagine what the company could earn if an infrastructure spending bill ever passed Congress.

Caterpillar raised its FY revenue outlook to a range of \$42 billion to \$44 billion, up from its previous outlook of \$38 billion to \$41 billion. The EPS guidance was increased to \$3.50 assuming revenue comes in at the middle of the expected range, up from an earlier estimate of \$2.10. On an adjusted basis, EPS of \$5.00 is now expected, up from \$3.75.

Cat is part of the S&P 500 Construction Machinery & Heavy Trucks index, which is up 19.7% ytd ([Fig. 11](#)). Expectations for the industry's earnings growth over the next 12 months have been improving since late 2015 and now stand at 17.2% ([Fig. 12](#)). Its forward P/E reached a high of 24.3 in December

2016, when forward earnings hit a cyclical bottom before falling to the current 19.2, which is still high relative to the past 20 years ([Fig. 13](#)).

(2) *General Electric*: The company that brings good things to life reported Q2 revenue of \$29.6 billion, down 12%, and adjusted EPS of 28 cents, down from 51 cents a year earlier. Much of the decline was due to the boost in results received last year from the sale of GE's appliance business. The results for the quarter beat analysts' expectations; however, the company issued a disappointing warning that its full-year results would be on the "weak side" of its previously announced range of \$1.60 to \$1.70 a share, reported a 7/21 *WSJ* [article](#). In addition, incoming CEO John Flannery won't unveil his 2018 outlook for GE until mid-November, a lifetime on Wall Street.

GE is a member of the S&P 500 Industrial Conglomerates stock price index, which has fallen 4.1% ytd ([Fig. 14](#)). Other members of the industry have turned in much stronger performances: Honeywell International has risen 18.5% ytd, 3M is up 11.5% even after pulling back this week in the wake of its earnings report, and Roper Technologies has rallied 27.5%. The S&P 500 Industrial Conglomerates is expected to generate 2.9% revenue growth over the next 12 months and 9.8% earnings growth ([Fig. 15](#)). At 17.9, the Industry's P/E has come off its high of 20.4 hit during July 2016.

(3) *Boeing*. The airplane manufacturer beat Q2 earnings expectations and raised its 2017 earnings estimates, which sent its shares flying. In Q2, the company earned an adjusted profit of \$2.55 a share, above analysts' consensus estimate of \$2.30 a share and up from last year's loss of 44 cents a share. The company is now calling for its 2017 earnings to fall between \$9.80 and \$10.00 a share, up from its previous guidance of \$9.20 to \$9.40 a share. The shares were up 9.9% Wednesday and have jumped 50.0% ytd.

Boeing is a member of the S&P 500 Aerospace & Defense stock price index, which is up 19.5% ytd through Tuesday's close ([Fig. 16](#)). The industry is expected to grow revenue by 3.4% over the next 12 months and earnings by 9.1% ([Fig. 17](#)). Its forward P/E is at a lofty 19.9, but its forward profit margin, at 7.9%, is below its record high of 9.0% in September 2014 ([Fig. 18](#)). The ability to improve margins, combined with the continued increase in defense spending domestically and abroad, could keep shares afloat.

(4) *Autos*. Auto manufacturers are lumped into the Consumer Discretionary sector, but their manufacturing heft makes them important to watch when tracking the Industrials sector. Both GM and Ford reported disappointing Q2 earnings, with strong US truck sales unable to offset the decline in US car sales.

Ford's Q2 operating income fell 16% to \$2.5 billion, and the company lowered its 2017 EPS guidance to a level that implies pre-tax operating earnings will be in a range of \$7.8 billion to \$8.7 billion. That's down from the previous outlook for \$9 billion of pre-tax operating earnings and below the \$10.4 billion earned last year, the 7/26 *WSJ* [reported](#).

GM's Q2 earnings dropped 42% to \$1.7 billion, hurt by costs associated with exiting markets in Europe, India, and South Africa. Both companies have elevated inventory levels. At GM, nearly 1 million vehicles are on dealer lots, equating to 105 days of supply.

Much of this dour news is baked into the S&P 500 Automobile Manufacturing stock index, which is down 2.3% ytd. Analysts are calling for the industry's revenue to drop 3.0% and earnings to fall 2.4% over the next 12 months.

## CALENDARS

**US. Thurs:** Durable Goods Total, Ex Transportation, and Core Capital Goods 3.2%/0.4%/0.3%, Jobless Claims 240k, Advance Merchandise Trade -\$65.0b, Kansas City Manufacturing Index, Chicago Fed National Activity Index 0.10, Weekly Consumer Comfort Index. **Fri:** Real GDP, Real PCE, and GDP Price Deflator 2.6%/2.8%/1.2%, Employment Cost Index 0.6%, Consumer Sentiment Index 93.1, Baker-Hughes Rig Count, Kashkari.(Bloomberg estimates)

**Global. Thurs:** Germany Retail Sales 0.2%*m/m*/2.7%*y/y*, Germany Gfk Consumer Confidence 10.6, UK Gfk Consumer Confidence -11, Japan CPI Total, Core, and Core-Core 0.4%/0.4%/-0.1% *y/y*, Japan Jobless Rate 3.0%, Japan Retail Trade 0.5%*m/m*/2.3%*y/y*, BOJ Summary of Opinions at July 19-20 Meeting. **Fri:** Eurozone Economic Confidence 110.8, Germany CPI 0.2%*m/m*/1.5%*y/y*, France GDP 0.5%*q/q*/1.6%*y/y*, Canada GDP 0.2%*m/m*/4.2%*y/y*. (DailyFX estimates)

## STRATEGY INDICATORS

**Stock Market Sentiment Indicators** ([link](#)): The Investors Intelligence Bull/Bear Ratio (BBR) rebounded further above 3.00, climbing to 3.65 this week from 3.46 last week, after falling the prior two weeks from 2.95 to 2.69, which was near its low for the year of 2.60. Bullish sentiment was up 10.2ppts the past two weeks to 60.2%—just shy of the 30-year high of 63.1% in late February—as the correction count sank 8.1ppts to 23.3%, the lowest reading since late February. Bearish sentiment was 2.1ppts lower at 16.5%—dropping to the bottom of its 16.5%-18.3% range shown most of this year. The AAll Ratio advanced last week to 57.9% after sliding the prior three weeks from 53.0% to 48.8%. Bullish sentiment rebounded to 35.5% following a three-week decline from 32.7% to 28.2%, while bearish sentiment fell for the second week from 29.9% to 25.8%.

**AC World ex-US MSCI** ([link](#)): This index is up 15.8% ytd in dollar terms after rising 1.7% in 2016. In local-currency terms, the index has risen a lower 8.7% ytd compared to its 4.1% gain for all of 2016. Local-currency forward revenues ticked down 0.6% *m/m*, but has risen 5.3% from a five-year low in March 2016 to near its highest level since November 2015. Forward revenues has been more stable longer term and is down just 5.5% from its October 2014 record high. Local-currency forward earnings has performed better, with a 0.2% rise *m/m* and a 16.3% rise from its six-year low in March 2016 to its highest level since November 2008, but remains 9.5% below its September 2008 record. Revenues are expected to rise 7.1% in 2017 and 4.8% in 2018 following a 0.9% decline in 2016, and earnings are expected to rise 15.7% (2017) and 9.2% (2018) after rising 3.4% (2016). Analysts are forecasting STRG of 5.9%, 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 11.7% 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. The forward profit margin forecast of 7.8% is at a seven-year high now. NERI was positive for a seventh month in July and for the first time since March 2011, but fell to 0.3% from 1.7% and is down 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 was unchanged *m/m* at 14.2, but is down 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 18.9% ytd in dollar terms after falling 1.2% in 2016. In euro terms, the price index is up a lower 7.6% ytd following a 1.8% gain for all of 2016. Euro-based forward revenues dropped 0.9% *m/m*, but has improved 2.3% from its six-year low in May 2016 to 1.9% below its cyclical high (August 2015) and 8.5% from its record high (September 2008). Euro-based forward earnings had stalled from 2011 to 2016—but is now 5.5% above its prior cyclical

high in September 2015 to its highest level since October 2011. It remains 23.9% below its record high (January 2008), but has improved 12.8% from its 23-month low in June 2016. Analysts expect revenues to rise 5.5% and 3.5% in 2017 and 2018, respectively, after falling 1.8% in 2016, but think earnings will rise 10.6% in 2017 and 9.4% in 2018 following a 4.9% rise in 2016. Forecasted STRG of 4.3% is down from a six-year high of 5.0% in April, but up from 2.0% in May 2016. Forecasted STEG of 9.8% is down from a 78-month high of 21.0% in February, which compares to a seven-year low of 5.7% in April 2016. STEG had been higher than LTEG (12.0%) since July 2016, but is trailing now. The forward profit margin has improved 1.7ppts to a six-year high of 7.4% 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 an eighth straight month in July, but fell to 3.0% from 7.6% in June. Those readings are down 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 14.4 is down from 14.7 in June 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 a 10% 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 23.1% ytd in US dollar terms after rising 8.6% in 2016. In local-currency terms, EM has gained a lower 18.3% ytd compared to a 7.1% gain in 2016. Local-currency forward revenues rose 0.8% m/m and is up 5.0% from a four-year low in June 2016 to 11.6% below its November 2014 record. Local-currency forward earnings has fared substantially better, also rising 0.8% m/m; it has improved 20.0% from April 2016's six-year low to just 1.9% below its January 2014 record. Revenues are expected to rise 10.0% in 2017 and 8.0% in 2018 following a 2.3% gain in 2016, leading to earnings gains of 20.3% (2017) and 11.4% (2018) following a 7.8% rise in 2016. Forecasted STRG of 9.1% 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 15.0% is down from 16.0% a month ago, and is below LTEG (17.7%) again. The implied profit margin is expected to improve to 6.9% in 2017 from 6.3% last year before edging up to 7.1% 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 77 months—ticked down m/m to -1.1% from -1.0%, which compares to a 75-month high of -0.6% in May and 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 up to a nine-month high of 12.5 in July from 12.1 in June, 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 23% discount to the World MSCI P/E, up from a 10-year-low 30% discount in August 2016.

**MSCI World & Region Net Earnings Revisions** ([link](#)): Analysts' recent earnings revisions through July suggest waning, but still strong optimism about profits across the world. All regions except EM Asia and the United States weakened m/m from their multi-year highs in May. The AC World MSCI's NERI was positive for a sixth month and for the first time since June 2011, but slipped 0.9ppts to 2.0% from 2.9% in June and is down from a 74-month high of 3.4% in May. The AC World Ex-US was positive for a seventh month, but dropped 1.4ppts to 0.3% from 1.7% and is down from a 76-month high of 2.7% in May. EM Eastern Europe and Europe were positive for a 10th straight month; EAFE and EMU were positive for an eighth month. Emerging Markets' NERI was negative for a 77th straight month, paced by 73 months of negative readings for EM Asia, 12 months for EM Latin America, and 10 months for EM Eastern Europe. July's scores among the regional MSCIs: United States (72-month high of 6.0% in July, unchanged from 6.0% in June), EMU (3.0, 7.6), Europe ex-UK (2.6, 6.8), AC World (2.0, 2.9), Europe (1.8, 5.1), EAFE (1.6, 4.0), AC World ex-US (0.3, 2.9), EM Eastern Europe (10-month low of 0.2, 1.5), EM Asia (-0.7, -0.9), Emerging Markets (-1.1, -1.0), and EM Latin America (-3.7, -2.3).

**MSCI Countries Net Earnings Revisions** ([link](#)): NERI was positive for 24/44 MSCI countries in July,

down from 29/44 in June, which was the highest since June 2010. NERI improved m/m in July for 10/44 countries, down from 18/44 in June and 32/44 in May, which had been the most since June 2016. Austria's NERI was at a 133-month high in July, followed by those of Chile (72-month high), Philippines (45), Czech Republic (26), and Greece (8). On the flip side, South Africa's was at a 95-month low, followed by those of Argentina (20), Pakistan (17), Russia (16), Hungary (15), and Peru (15). The 16-month positive NERI streak for Hungary is the best, followed by those of Austria (14), Germany (10), Hong Kong (9), Poland (9), and Turkey (9). Brazil's NERI has been negative for 85 straight months, followed by the negative streaks of South Africa (38), India (33), and New Zealand (14). NERI turned negative in July for the first time in seven months for Norway, in four months for Argentina, and in three months for Belgium, Canada, and Malaysia. Hungary's NERI has been the strongest recently, with positive readings in 26 of the past 27 months.

**S&P 500 Q2 Earnings Season Monitor** ([link](#)): With over 34% of S&P 500 companies finished reporting Q2-2017 results, their revenue and earnings surprise data are better than at the comparable point of the Q1 season, but y/y growth comparisons are mixed. Of the 171 companies in the S&P 500 that have reported, 78% exceeded industry analysts' earnings estimates by an average of 6.7%; they have averaged a y/y earnings gain of 12.5%. At the same point during the Q1-2017 reporting period, a slightly higher percentage of companies (79%) in the S&P 500 had beaten consensus earnings estimates by a lower 6.0%, and earnings were up a lower 11.7% y/y. On the revenue side, 73% beat sales estimates so far, with results coming in 1.4% above forecast and 3.4% higher than a year earlier. At this point in the Q1 season, a lower 63% had exceeded forecasts, companies reported revenues a lower 0.9% above forecast, and sales rose a slightly higher 4.4% y/y. Q2 earnings results are higher for 68% of companies vs 75% at the same point in Q1, but revenues are higher for 81% vs 79% a quarter ago. These figures will change markedly as more Q2-2017 results are reported in the coming weeks, but the early results are encouraging and suggest a return to more normalized growth rates following the Energy recession of 2015-2016. Q2-2017 should mark the fourth straight quarter of positive y/y earnings growth, but we expect growth will fall back into the single digits following Q1's double-digit percentage earnings growth, which was the first double-digit quarter seen since Q3-2011.

## US ECONOMIC INDICATORS

**New Home Sales** ([link](#)): June new home sales rose for the fifth time this year, climbing 0.8% m/m and 11.3% ytd to 610,000 units (saar). (These sales are tabulated when contracts are signed, making new home sales a timelier barometer of the residential market than existing home sales.) While sales are improving, they are less than half what they were at the peak of the housing market bubble in 2005, reflecting a shortage of homes rather than weak demand. Builders are facing headwinds of a shortage of workers and land, along with rising materials costs. In June, there were 272,000 new single-family homes on the market, the highest level since June 2009 but still less than half of the peak recorded during the housing boom. The months' supply of homes edged up from 5.3 to 5.4 in June, just below April's high for this year of 5.6 months. Meanwhile, July's NAHB's Housing Market Index fell for the third time in four months to an eight-month low of 64 after reaching a cyclical peak of 71 in March. All three components posted losses over the period, though remain at healthy levels: current sales conditions (to 70 from 77 in March), sales expectations in the next six months (73 from 78), and buyer traffic (48 from 53). NAHB's chief economist noted, "The HMI measure of current sales conditions has been at 70 or higher for eight straight months, indicating strong demand for new homes. However, builders will need to manage some increasing supply-side costs to keep home prices competitive."

## GLOBAL ECONOMIC INDICATORS

**UK GDP** ([link](#)): The UK economy lacks momentum, experiencing "a notable slowdown in the first half of this year," according to ONS. Real GDP rose 0.3% during Q2 after only a 0.2% gain during Q1, posting

its weakest first half of any year since 2012. The service sector drove economic growth last quarter, accelerating 0.5%, helped by retailers and hotels & restaurants, along with a booming film industry. The remaining three industrial groupings show construction and production contracted 0.9% and 0.5%, while agriculture rose 0.6%. Within production, manufacturing sank 0.5%, primarily auto-related. On Monday, the IMF downgraded its 2017 economic outlook for the UK, predicting growth of 1.7% compared with an earlier estimate of 2.0%, and forecasted a further slowdown to 1.5% next year. (The second release of GDP data, due August 24, will show the expenditure breakdown.)

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