



MORNING BRIEFING

August 10, 2017

Fast & Furious

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

(1) Pushing and shoving with Lil' Kim. (2) Two wild and crazy fearless leaders. (3) No fast and furious reaction from the stock market. (4) Real world target practice for THAAD? (5) Reviewing the track record of the misery-adjusted forward P/E. (6) Americans like fixer-uppers almost as much as they like zombies. (7) Life's sweet for homebuilders. (8) Semiconductors are looking chipper. (9) Hotels are packed, but Marriott says it's hard to raise room rates.

Strategy I: Fire & Fury. I said what I had to say about the decreasing odds of keeping the peace with North Korea in my piece in Monday's *Morning Briefing* titled "Lil' Kim & Big THAAD." Push may be coming to shove faster than anyone expected given the escalation of hostile rhetoric between the fearless leader of North Korea and our fearless leader, President Donald Trump, who on Tuesday threatened a "fire and fury" response to any further provocations by North Korea. The stock market's reaction on Wednesday to the mounting tensions wasn't fast and furious, despite lots of loose talk suggesting that both sides are ready to go nuclear.

August and September have a history of being tough months for the stock market. Yet, so far, even talk of loose nukes isn't triggering a meltdown in stock prices, which could still happen, I suppose. However, it's more likely that the Chinese will wake up and conclude that they may be dealing with two wild and crazy guys, and they must do something to rein in the one who is in their neighborhood.

Another possibility, which might elicit a serious adverse reaction in the stock market, would be another test missile launch by North Korea that is immediately shot down by an American THAAD anti-missile missile. That would also wake up the Chinese to realize it's time to replace their crazy guy in Pyongyang with another guy, one who remains beholden to their interests but isn't deranged.

Strategy II: Less Misery. On a lighter note, I noted yesterday that the Misery Index, which is simply the sum of the unemployment rate and the inflation rate, is falling along with the jobless rate ([Fig. 1](#)). I observed that the sum of the Misery Index and the S&P 500 forward P/E has averaged 23.9 since 1979, when the data start for this homemade Misery-Adjusted Forward P/E ([Fig. 2](#)).

This valuation measure was 23.6 during June, suggesting that the market is fairly valued. Almost all the other valuation measures show that the S&P 500 is somewhere between very overvalued to grossly overvalued. Yesterday, I also observed that if the inflation rate remains steady while the unemployment rate continues to fall, that would lower the Misery Index and provide more room for the P/E to rise and still represent fair value.

Admittedly, the Misery-Adjusted Forward P/E isn't flawless. It correctly warned that stocks were overvalued prior to the bear markets of the early 1980s and 2000s. It did not anticipate the last bear market, but that's because the problem back then was overvaluation of real estate, not stocks. Our conclusion remains the same: Stay invested, but watch out for the crazy guy in North Korea.

Industry Focus I: Homebuilding. TV shows often reflect the best and the worst of American culture.

In Q2, a home renovation show attracted more eyeballs watching cable TV than any of the crime shows or news programs available. “Fixer Upper,” on HGTV, is about a couple, Chip and Joanna Gains, who help folks buy and renovate run-down homes in Waco, Texas. They are the perfect couple, never fighting while encountering termites or raising four kids.

According to a 6/30 [article](#) in *Variety*, the rating for the 3/28 “Fixer Upper” episode was second only to that of an April episode of “The Walking Dead,” a series about life after a zombie epidemic. We haven’t quite figured out why Americans are obsessed with zombies, but the popular home improvement shows on HGTV are just the latest confirmation that the US real estate market has been reinvigorated.

More traditional indicators reinforce that assertion. New single-family home sales have climbed nicely since the 2011 bottom, but aren’t anywhere near the peak of 1.4 million units (saar) during July 2005 ([Fig. 3](#)). Meanwhile, inventories of existing single-family homes remain near post-recession lows, equaling 4.3 months’ supply on the market in June. Throw in a 4.3% unemployment rate and low-cost mortgages, and you have an environment any homebuilder would love.

Homebuilders are throwing off consistent, strong earnings growth this year, and more of the same is expected in 2018. The S&P 500 Homebuilding stock price index has risen 31.7% ytd through Tuesday’s close, beating the broader market and breaking out of a three-year trading range ([Fig. 4](#)). Analysts expect the Homebuilding industry to generate 12.4% revenue growth over the next 12 months and 17.7% earnings growth over the same period ([Fig. 5](#)). Meanwhile, the industry’s forward P/E ratio is a below-market 11.3 ([Fig. 6](#)).

Here’s Jackie’s take on what two industry members—D.R. Horton and PulteGroup—recently divulged in their upbeat earnings reports:

(1) *Building on strength*. D.R. Horton, the country’s largest builder by market cap, reported that for its fiscal Q3, ending June 30, the number of net homes it sold increased by 11% y/y, revenue jumped 17.0%, and net income improved by 15.7%. The company more than met its goal of producing double-digit annual growth in net revenue and pretax profits.

Horton also sounded upbeat about the future. It announced a \$560 million acquisition of a 75% stake in Forestar Group, a publicly traded residential real estate development company. It also provided fiscal Q4 guidance for revenue that was higher than its previous announced range. In addition, Horton gave FY 2018 guidance of 10% to 15% revenue growth, excluding the Forestar acquisition.

“[R]ight now, what we’re seeing is a very solid, very consistent high-demand, low-inventory market that feels like it’s going to continue,” said CEO David Auld, according to the 7/26 earnings conference call [transcript](#). Analysts expect the company’s FY 2017 earnings to grow 17.8% and its FY 2018 earnings to grow 12.2%.

(2) *Almost all’s good at Pulte*. PulteGroup reported 12% growth in orders and Q2 revenues, which led to a 16.5% jump in adjusted net income and a 27% increase in adjusted earnings per share thanks to share buybacks. Adjusted earnings excluded a charge related to selling underperforming land. The average sales price of a home increased by 6% y/y to \$390,000.

Pulte’s earnings conference call had two notes of caution. The company said it was giving discounts of \$14,000 on higher-end homes in select markets where there is more inventory. It also noted that wages, concrete, and lumber expenses could come in at the high end of the range the company has forecasted.

But overall, the transcript's tone was upbeat, both about the current environment and the future. "We continue to see positive buyer sentiment and generally improving demand trends across our markets. Driven in part by an expansion of the first-time buyer segment, housing demand is supported by a variety of positive factors, including an improving economy with low unemployment, high consumer confidence, low interest rates and supportive demographic," said CEO Ryan Marshall, according to a [transcript](#) of the company's Q2 earnings conference call. He concluded: "Given this backdrop, we remain constructive on the market and the potential for several more years of growth in overall housing demand."

Industry Focus II: Semiconductors. Semiconductor sales continued to power higher in June, a good omen both for the industry and the Information Technology sector as a whole. Worldwide semiconductor sales increased by 2.0% in June m/m and 23.7% y/y to new record highs, according to the latest [report](#) by the Semiconductor Industry Association.

Worldwide semi sales often align nicely with the S&P 500 Semiconductors industry's forward earnings ([Fig. 7](#)). That would imply strong results are forthcoming at semiconductor companies. However, analysts are calling for the S&P 500 Semiconductors industry's revenue to climb 6.2% over the next 12 months, and earnings are predicted to rise only 9.0%. That's down sharply from the rapid 30.0% earnings growth forecasted for this year ([Fig. 8](#)).

Strong worldwide semiconductor sales may imply that Wall Street analysts have grown too conservative about the industry's fortunes. Chips are certainly in great demand thanks to the advent of automated cars, the Internet of Things, and the upcoming arrival of the latest iPhone. If analysts' sights aren't high enough, the S&P 500 Semiconductor index, which is up 13.8% ytd, could have room to run further ([Fig. 9](#) and [Fig. 10](#)). The industry's forward P/E of 15.2 certainly gives it room to do so.

The other, more gloomy possible explanation for low forward earnings estimates could be analysts expect semi prices to fall in the not-so-distant future, which would put pressure on the industry's bottom line. There are rumblings that China plans to jump into the industry, and companies there are building mammoth factories that could lead to oversupply by 2020, a fantastic 7/27 [WSJ article](#) reported. But that seems like something to worry about next year.

Industry Focus III: Hotels. Conference call transcripts aren't exactly beach reading, but every once and a while they contain a nugget of information that makes the slog worthwhile. Take Marriott International's Q2 conference call [transcript](#) of 8/2. The company enjoyed nearly 80% occupancy in North America, and US corporations have posted strong earnings that should mean more corporate traveling. But despite the strong macro environment, Marriott reduced its North American revenue per available room (RevPAR) estimate to 1%-2% from 1%-3%. Where's the pricing power the company should be enjoying in this environment?

CEO Arne Sorenson blamed "fairly anemic" US GDP, but he also called out the impact of technology. "It is a market with radical transparency in pricing. And that may have some impact on our ability to move rates in this cycle compared to prior cycles."

Jared Shojaian at Wolfe Research picked up on this thread and asked whether the transparency Sorenson mentioned was related to third-party websites' monitoring prices, online travel agencies, home sharing, or some combination. Sorenson's response:

"Well, I think it's all of it. But it's not particularly focused on home sharing or the disruptors in the space. It's much more about just the ubiquity of information. And I think with each passing year, it becomes simpler and simpler to know the rates at every single hotel, quite simply, within our own system. So,

you've got that transparency on Marriott.com just as you do through other platforms. And with an increasing participation in the industry of the franchise community with individual pricing decisions that are being made by individual hotels, I think that's the world we live in. It does not mean that there won't be ability to drive rate in the future. We do have the ability to drive rate, certainly on midweek nights and others where the hotels are effectively full. But I don't think it's quite the environment we might have had in years past where probably there's a little bit more flexibility to do that."

And that's why you read transcripts. (Maybe Fed officials need to start reading transcripts too.)

CALENDARS

US. Thurs: Jobless Claims 241k, PPI-FD Headline, Core, and Core Less Trade Services 0.1%/0.2%/0.2%, Weekly Consumer Comfort Index, Treasury Budget, EIA Natural Gas, Dudley. **Fri:** Headline & Core CPI 1.8%/1.8% y/y, Baker-Hughes Rig Count, Kaplan, Kashkari. (Bloomberg estimates)

Global. Thurs: UK GDP 0.3%, UK Headline & Manufacturing Industrial Production -0.1%/0.7% y/y, China New Yuan Loans 790b, China Aggregate Financing 1,000b, China M2 9.4% y/y, Lowe. **Fri:** Germany CPI 0.4%/m/m/1.7%/y/y. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators ([link](#)): Our Bull/Bear Ratio (BBR) this week slipped to 3.38 after climbing the prior two weeks from 3.46 to 3.70—which was the highest since the last week of February; it was below 3.00 seven of the prior eight weeks. Bullish sentiment edged down for the second week to 57.5%, following a 10.2ppts surge the prior two weeks to 60.2%, remaining near the 30-year high of 63.1% in late February. The correction count edged up for the second week to 25.5% after an 8.1ppts drop the previous two weeks to 23.3%—which was the lowest reading since late February. Bearish sentiment ticked up to 17.0% this week after falling the prior four weeks from 18.8% to 16.2%. The AAll Ratio dipped to 52.9% last week after advancing the prior two weeks from 48.8% to 58.6%. Bullish sentiment rose from 34.5% to 36.1% last week, while bearish sentiment climbed from 24.3% to 32.1%.

S&P 500 Earnings, Revenues & Valuation ([link](#)): S&P 500 consensus forward revenues and forward earnings surged 0.5% and 1.0% w/w, respectively, to record highs last week. The forward profit margin forecast edged up to a record high of just over 11.0%. 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 5.2% from 5.3%, and is down from 5.8% in late January, which was the highest since May 2012 and compares to a cyclical low of 2.7% in February 2016. Forward earnings growth was steady at an 18-week low of 10.8% and is down from a six-month high of 11.3% in early July. It remains near January's 11.7%, which was the highest since October 2011 and compares to a cyclical 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 forward growth rate forecasts for revenues (STRG) and earnings (STEG) for Industrials, Materials, Tech, and Utilities. However, Energy's contribution to forward growth peaked at the start of 2017. Looking at last week's results, the S&P 500 ex-Energy's STRG of 4.8% is 0.4ppt lower and STEG of 9.3% is 1.6ppts lower. However, the S&P 500 ex-Energy forward profit margin was at a record high of 11.6%, which is its first since August 2007. Due to the w/w improvement in earnings, valuation fell to 17.8 from 18.0 a week earlier, which had matched its 13-year high of 18.0 in early March and compares to a 15-month low of 14.9 in January 2016. The price-to-sales ratio edged down to 1.96 from a record high of 1.97. On an ex-Energy basis, valuation fell to 17.4 from a 21-week high of 17.5, which compares to 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 all 11 sectors, and forward earnings rose for all but Consumer Discretionary. 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 recent freefall in forward revenues and earnings took a pause in the latest week. The sector's forward revenues stabilized at a nine-month low and its forward earnings remained near an eight-month low. The forward P/S ratio rose w/w for 4/11 sectors, and the P/E ratio rose w/w for 3/11 sectors. These three sectors saw both measures rise w/w: Financials, Telecom, and Utilities. Health Care had been surging recently; its P/E of 16.2 and P/S of 1.72 are stalling near their highest levels since August 2015, and remain well below their early 2015 highs of 17.9 and 1.88, respectively. Financials' P/E is up from 12.0 before the election to 14.0, and is approaching the post-election high of 14.6 in early March. With Energy's forward revenues and earnings up from cyclical lows in early 2016, its valuations are coming back to Earth; its P/S ratio of 1.33 compares to a record high of 1.56 in May 2016, and its P/E of 27.9 is down from a record high of 57.5 then. Higher y/y margins occurred for only 7/11 sectors in 2016, but 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. These five sectors had their forecasted 2017 margin improve w/w: Financials, Health Care, Tech, Real Estate, and Utilities. Edging down w/w were Consumer Discretionary and Consumer Staples. Here's how the 11 sectors rank based on their current 2017 forecasts: Information Technology (to 20.1% in 2017 from 19.2% in 2016), Real Estate (18.5, 25.3), Financials (15.7, 14.3), Telecom (11.4, 11.2), Utilities (11.0, 11.4), S&P 500 (10.6, 10.1), Health Care (10.5, 10.3), Materials (9.8, 9.4), Industrials (9.2, 8.9), Consumer Discretionary (7.3, 7.2), Consumer Staples (6.5, 6.4), and Energy (3.9, 1.1).

US ECONOMIC INDICATORS

Productivity & Labor Costs ([link](#)): Productivity growth remained weak last quarter, while growth for all of 2016 was revised down to -0.1%—the first calendar-year decline since 1982. Productivity expanded by a sluggish 0.9% (saar) last quarter, following a 0.1% gain during Q1, as output (3.4% saar) grew at a faster rate than hours worked (2.5). Gains in labor compensation slowed dramatically from Q1's substantial upward revision: Hourly compensation advanced 1.6% (saar) during Q2—less than a third of Q1's 5.5% pace, while unit labor costs increased only 0.6% after a 5.4% jump during Q1; both measures were first reported up 2.2% during Q1. On a year-over-year basis, nonfarm productivity expanded only 1.2% as output and hours worked increased 2.7% and 1.5%, respectively; hourly compensation rose 1.0% y/y, while unit labor costs contracted 0.2%.

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