MORNING BRIEFING
August 23, 2017

Out West & Down South

See the collection of the individual charts linked below.

(1) Tooling around La La Land with a Klingon at the wheel. (2) Hollywood shake-up: talent and consumers are kings and queens. (3) Off-the-charts demand for new content sends competition soaring. (4) The next-Netflix wannabes include Apple. (5) Old studio "suits" learn new trick: stream direct to consumers. (6) Netflix and Amazon stocks amply valued for heady growth prospects. (7) Mexico is on a roll, with 16 quarters of GDP growth and stocks up 30% ytd. (8) Let the NAFTA talks begin!

Industries: That's Entertainment. I am visiting our accounts on the West Coast this week. They are all institutional investment managers. None of them are in the entertainment business. However, to take me around town in Los Angeles, I always hire the same limo driver, who once had a role as a Klingon on the television hit series "Star Trek." He always brags about the Hollywood stars he drove around in recent months. Silicon Valley is also star-struck. The largest tech titans are spending billions to become movie moguls to gain more subscribers. Apple is the latest to announce it's willing to spend big bucks, following in the footsteps of Netflix and Amazon.

It's not like the entertainment industry was starved for capital. Traditional Hollywood types—like Disney, 21st Century Fox, CBS, and many others—have deep pockets that funded the industry for years. But now the competition has hit a frenzied level that has left the studios scrambling, the talent calling the shots, and consumers with plenty of choice. I asked Jackie to have a look at the business of show business from her home office on the East Coast. She has done so once before this year. Here is her Take #2 on the disruptive impact that Silicon Valley is having on this industry:

(1) *Apple takes a bite*. The 8/16 *WSJ* reported that Apple plans to spend roughly $1 billion to buy and produce original content over the next year in an effort to fill its streaming-music service or possibly launch a new video-focused service. That follows the company's move in June to hire Jamie Erlicht and Zack Van Amburg from Sony to oversee its content acquisition and video strategy.

Apple appears to be cracking open its sizable piggy bank because its iTunes business may be in danger of becoming passe. "Apple's existing video business—movie and TV-show rental via iTunes—has been challenged by the rise of Netflix and other video-subscription services that charge a monthly fee. Last year, iTunes generated an estimated $4.1 billion in revenue, but its share of the movie rental-and-sales market has dropped below 35% from about 50% in 2012," the *WSJ* reported.

Meanwhile, Netflix and Amazon strike deal after deal to create more content. Amazon struck an agreement to stream Thursday Night Football games for about $50 million, or five times what Twitter paid the NFL for the rights to stream the games last year, noted a 4/5 *Los Angeles Times* article. Earlier this month, Netflix bought comics publisher Millarworld, which includes comic book writer Mark Millar and the many characters Netflix hopes to turn into TV shows and movies.

(2) *Talent wars heat up*. It takes a lot of humans to create all this content, so times are good for Hollywood producers and talent. Netflix entered into an exclusive agreement with Shonda Rhimes, who previously had worked with ABC, where she created "Scandal" and "Grey's Anatomy." It also lured

David Letterman out of retirement with a deal to do a six-episode talk show next year. And Amazon struck a development pact with Robert Kirkman, creator of AMC Network's "The Walking Dead."

"Netflix's heavy spending continues to raise eyebrows in Hollywood. It often doubles salaries to lure talent away from traditional players. The company's spending on new and acquired programs is expected to be more than $6 billion this year, compared with $5 billion a year ago. That is more than twice what HBO spends and five times as much as 21st Century Fox's FX or CBS Corp.'s Showtime," an 8/14 *WSJ* article observed.

(3) *Old media fights back*. With the tech titans looming large, the old dogs of media are learning new tricks. They're attempting to stream their entertainment directly to consumers, cutting out the middlemen like Netflix, Amazon, and the cable and satellite operators.

Time Warner's Turner Sports is launching a direct-to-consumer subscription service that will air the Union of European Football Associations' Champions League and Europa League soccer matches, noted an 8/17 *WSJ* article. The move followed Disney's announcement that it plans to create a subscription streaming service that would bring ESPN and its entertainment programing directly to consumers. CBS also plans to stream a digital sports service, in addition to the news service and CBS network programing that it already streams to consumers.

(4) *Earnings and valuation*. These various players, each attempting to bring TV shows and movies to our big and little screens, are in very different industries with very different growth and valuation profiles.

The S&P Movies & Entertainment industry includes Disney, Fox, Time Warner, and Viacom. Its stock price index has fallen 1.2% ytd through Monday's close, making it essentially flat over the past two years (*Fig. 1*). The industry is expected to grow revenues by 5.0% and earnings by 8.5% over the next 12 months, yet it has a below-market P/E of 14.8 (*Fig. 2* and *Fig. 3*).

The S&P 500 Cable & Satellite stock price index—which contains Charter Communications, Comcast, and DISH Network—is up 22.3% ytd (*Fig. 4*). Analysts forecast that the industry will produce revenues growth of 7.2% and earnings growth of 14.7% over the next 12 months (*Fig. 5*). For that slightly faster earnings growth, the industry boasts a forward P/E of 24.1, which is near its all-time high (*Fig. 6*).

Netflix and Amazon both are part of the S&P 500 Internet & Direct Marketing Retail industry along with Expedia, Priceline, and Trip Advisor. That industry's index is up 26.9% ytd (*Fig. 7*). Analysts see the industry producing revenue growth of 21.7% and earnings growth of 32.5% over the next 12 months (*Fig. 8*). For that astronomical growth, investors bestow a 68.7 forward P/E on the industry (*Fig. 9*).

Mexico: Not Trump's Chump. The closest I will get to Mexico on this business trip is Newport Beach, California. Mexico is among the strongest-performing markets this year, evidenced by the 30.2% advance ytd of the MSCI Mexico Share Price Index in dollars through 8/21. In contrast, the S&P 500 has advanced 8.5% (*Fig. 10*).

Yes, Mexico. That's the same Mexico that President Trump loves to vilify and berate and threaten to wall off from the US. Through Q2, the second-largest economy in Latin America has produced 16 straight quarters of economic growth, witnessed its exports climb to a record high of $198 billion, and created a record number of jobs as well.

That's the Mexico that came to the table last week, joining teams from Canada and the US, to renegotiate the 23-year-old North American Free Trade Agreement, or NAFTA, which directs $1 trillion of trade among the nations. Though enacted into law in January 1994 under President Bill Clinton, the agreement was formulated a few years earlier under the administrations of President George H.W. Bush, Canadian President Brian Mulroney, and Mexican President Carlos Salina.

President Trump made scuttling NAFTA and other trade agreements a centerpiece of his election campaign, railing against trade deficits. Only more recently has he softened his tone and adopted a more conciliatory attitude. In a meeting with Mexican President Enrique Pena Nieto at a two-day Group of 20 economic summit in Hamburg, Germany on July 7 and 8—their first since Trump won the election—Trump called Nieto his "friend" and described making "very good progress" in their discussions of NAFTA, according to a 7/7 Reuters article.

While Trump's success in November promptly led to a selloff in the Mexican peso, driving it to record lows against the US dollar on fears that foreign investment would shrivel up, business conditions and monetary policy have combined to lift the peso to its highest levels in more than a year. It is now ranked among the best-performing currencies against the US dollar y/y and ytd (*Fig. 11* and *Fig. 12*).

The opening round of the NAFTA talks gives us a good excuse to examine more closely the health of the Mexican economy (*Fig. 13*). While the Mexican stock market appears fairly valued based on its forward P/E of 17.2 compared with a forward earnings growth rate of 14.2%, forward earnings estimates have been rising (*Fig. 14*). That, along with a surprising resiliency and strong consumer momentum, could lead to continued upside. Viva Mexico! I asked Sandy Ward—who, like Jackie, is an alumnus of *Barron's*—to update us on the fiesta south of the border:

(1) *GDP.* The economy grew faster than expected in the June quarter, up 0.6% q/q compared with an estimated 0.2%. On a y/y basis, it met expectations with a gain of 1.8% (*Fig. 15*). But that was a marked deceleration from Q1 growth of 2.8%. Much of the strength came from the service sector, up 3.2% y/y but slightly diminished from the 3.7% delivered in Q1.

Robust consumer spending played a big role in driving the services sector higher. Consumer confidence continues to rebound from the depths to which it had sunk after Trump's election. The seasonally adjusted index hit a y/y high in July of 86.6, up from 85.1 in June. Newfound optimism surrounding the NAFTA renegotiations and a vastly improved employment picture go a long way to explain the positive consumer sentiment.

Also, remittances from the US, an important source of income for Mexicans, have been showing steady gains, rising 4.5% y/y in June after a 4.3% gain in May. In a notable recent shift, the number of transactions has dropped, but the average value of the remittances increased for the fifth straight month, according to an 8/2 FocusEconomics report—an indication that wages are rising for Mexican workers in the US. That perhaps explains the keen demand for big-ticket items, despite a sharp rise in inflation.

(2) *Exports.* Mexican exports showed powerful gains in the first six months of the year, increasing 10.4% y/y, according to a 7/28 article in the *FT* based on statistics from Mexico's National Institute of Statistics and Geography (*Fig. 16*). Manufacturing exports took the lead, rising 9.2% y/y, buoyed by automotive exports (finished cars and auto parts), which were up 10.9% y/y. A jump in the value of oil exports also helped as the category surged 30.5% y/y in the first half to $10.6 billion. Total exports to the US were up 7.7%, accounting for 82.2% of Mexican exports.

Automotive exports to the US—Mexico's No. 1 export category to the US—expanded by 9.8% and represent 76.8% of the total of exports to the US. Those figures go hand in hand with record-setting auto production numbers: In June, production of light vehicles reached 334,606, up 4.9% y/y. For the first half of 2017, 1,884,315 vehicles were produced, for a gain of 12.6% y/y. In a twist of fate, concerns about the future of NAFTA have resulted in increased trade flows between the US and Mexico, according to the 7/28 *FT* article.

(3) *Imports.* Mexico imported about as much as it exported in the first half of 2017: Imports expanded by 7.8% to $200 billion. Electrical machinery and equipment and computers are the top one and two import categories. The third-biggest and fastest-growing category: vehicles.

(4) *Industrial production.* Manufacturing output was the bright spot in an overall weak June report, up 2.7% y/y (*Fig. 17*). Mining production plummeted by 7.6% y/y, and utilities had a 0.9% drop in output. The construction sector stayed stable.

(5) *Foreign investment.* After slumping sharply in Q4-2016, foreign investment in Mexico rebounded in Q1 to $7.9 billion. Continued gains are likely following reforms that have opened the energy sector to foreign firms coupled with significant new offshore oil discoveries that are creating excitement. The Italian oil group Eni has made two substantial finds in the shallow-water Amoca field since early this year, and a consortium including Houston-based Talos Energy, Mexico's Sierra Oil & Gas, and the UK's Premier Oil & Gas has uncovered one of the largest shallow-water oil field finds in the past 20 years, according to a report in the 8/16 *FT.*

Vista Oil & Gas, Mexico's first special-purpose acquisition company, raised $650 million earlier this month in the country's third-largest IPO since 2015, notes an article in the 8/10 *FT*. The offering proceeds exceeded expectations. Vista is backed by Miguel Galuccio, former CEO of Argentina's YPF, and Riverstone Holdings, a private equity firm and energy specialist. Earlier this month, Zuma Energia—a Mexican renewable energy group 80% owned by the UK-based private equity firm Actis—secured $600 million in project financing to build Mexico's largest wind farm, reported an 8/8 *FT* story.

In May, automotive supplier Lear Corp. opened its 45th plant in Mexico in Zacatecas, investing $21 million and hiring 1,300 workers, according to a 5/20 *Mexico Now* story. It plans to spend an additional $9.5 million to expand the facility and add another 600 jobs in 2018. In the past four years, Lear has opened 11 plants in Mexico and estimates that it will employ 56,000 workers by the end of this year.

Walmex, as Walmart de Mexico is known, announced in December that it planned to invest $1.3 billion over the next three years to improve its logistics infrastructure, build new distribution centers, expand existing ones, and add 10,000 permanent new jobs, according to a 12/7/16 Reuters report. Said CEO Guilherme Loureiro, "We are convinced that Mexico is a country rich in opportunities," noting that Walmart has invested $2.6 billion in Mexico in the previous four years.

(6) *Jobs.* The unemployment rate is at the lowest level in more than a decade as Mexico creates jobs at a record pace, according to a 7/18 Bloomberg report (*Fig. 18*). Labor law changes, creating more flexibility in contracts and more accountability in corporate payrolls, have led to 517,000 Mexican workers gaining access to social security in the first half of this year, up 17% from the same period in 2016 and the most in at least two decades.

The formalization of job arrangements provides workers with health and retirement benefits. The percentage of workers in the so-called "informal" economy—including artisans, construction workers, vendors, and domestic workers—continues to shrink and is now estimated at 57.2% compared with 58.0% in 2016 and 60.0% in 2009 at the height of the global financial crisis. Importantly, the formally registered workers are responsible for three-quarters of Mexico's economic production, according to a 12/17/16 Associated Press article, based on data from Mexico's National Statistic Institute.

(7) *Inflation.* After the Bank of Mexico raised its overnight interest rate to 7% in June, the seventh straight increase since September 2016, the central bank suggested that it was done tightening, according to a 6/22 *WSJ* story (*Fig. 19*). The rate hikes were a response to US rate increases and designed to give a boost to the peso as well as respond to a government-ordered 20% hike in gasoline prices that, in turn, drove transportation costs higher (*Fig. 20*). Despite the rise in inflation, consumers are confounding economists by continuing to spend.

Rose-colored glasses may be the best for viewing Mexico at this juncture. What's that they say about success being the best revenge?

CALENDARS

US. Wed: New Home Sales 610k, Composite, Manufacturing, and Non-Manufacturing PMI Flash Estimates 54.3/53.2/54.8, MBA Mortgage Applications, EIA Petroleum Status, Kaplan. **Tues:** Jobless Claims 237k, Existing Home Sales 5.565mu, Kansas City Fed Manufacturing Index, Weekly Consumer Comfort Index, EIA Natural Gas Report, Jackson Hole Economic Policy Symposium. (Bloomberg estimates)

Global. Wed: Eurozone Consumer Confidence -1.8, Eurozone Composite, Manufacturing, and Non-Manufacturing PMI Flash Estimates 55.5/56.3/55.4, Germany Composite, Manufacturing, and Non-Manufacturing PMI Flash Estimates 54.7/57.7/53.3, France Composite, Manufacturing, and Non-Manufacturing PMI Flash Estimates 55.5/54.5/55.8, Japan M-PMI Flash Estimate, Draghi. **Tues:** UK GDP 0.3%q/q/1.7%y/y, Japan Headline, Core, and Core-Core CPI 0.4%/0.5%/0.1% y/y. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Sectors Net Earnings Revisions (*link*): The S&P 500's NERI was positive for a fourth straight month in August, its longest positive streak since it rose for five months through September 2014. NERI dropped to a still-strong 4.0% in August from 5.9% in July, and from a six-year high of 6.2% in June. NERI improved m/m for 4/11 sectors in August and was positive for 7/11 sectors (compared to seven improving in July and eight positive). That's the lowest number of sectors to improve m/m in 13 months. Tech topped all sectors in August for the first time in nine months, with its highest reading in the 79 months since January 2011. Consumer Discretionary retuned to negative territory following its first positive reading in 13 months during July. Tech has the longest positive NERI streak of 13 months, the best since August 2011 when a 28-month streak ended. Financials has the next best positive streak at 11 months, followed by Industrials (6). Telecom is the worst recently, with 16 straight months of negative NERIs, followed by Energy (5). Here are the sectors' August NERIs compared with their July readings, ranked in descending order: Tech (15.4% in August, up from 13.2% in July), Health Care (10.7 [14-month high], 10.4), Financials (9.3, 10.1), Industrials (9.1, 18.8 [85-month high]), Real Estate (2.7, 9.4 [36-month high]), Utilities (2.2, 3.7 [32-month high]), Consumer Staples (0.4, -0.2), Materials (-0.8, 1.3), Consumer Discretionary (-1.5, 0.4 [13-month high]), Telecom (-1.6 [16-month high], -32.1), and Energy (-22.8 [16-month low], -15.5).

S&P 500 Earnings, Revenues & Valuation (*link*): S&P 500 consensus forward revenues edged up w/w for the fifth time in six weeks to 0.1% below its early August record high, and forward earnings rose w/w to a new record high. The forward profit margin forecast edged down w/w to 11.0% from a record high of 11.1%. The profit margin's record high was 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 was steady w/w at 5.3%, but 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 edged down to a 20-week low of

10.8% from 10.9%, 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 0.5ppt lower and STEG of 9.2% is 1.6ppts lower. However, the S&P 500 ex-Energy forward profit margin was steady for a third straight week at a record high of 11.7%, which is its first since August 2007. Due to the w/w drop in the index price, valuation fell to an 18-week low of 17.2 from 17.7 a week earlier, which is down from late July's 13-year high of 18.0 and compares to a 15-month low of 14.9 in January 2016. The price-to-sales ratio was steady at 1.96, slightly below late July's record high of 1.97. On an ex-Energy basis, valuation was steady at 17.4, down from late July's 21-week high of 17.5, and 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 6/11 sectors, and forward earnings rose for 3/11. Consumer Staples, Materials, and Tech had both measures rise w/w. 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 remains near a 10-month low, and its forward earnings is around an eight-month low. The forward P/S ratio rose w/w for 5/11 sectors, and the P/E ratio rose w/w for 6/11 sectors. These four sectors saw both measures rise w/w: Materials, Real Estate, Tech, and Utilities. Health Care had been surging recently; but its P/E of 16.2 and P/S of 1.72 are now 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 13.8, but remains below 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 1.26 compares to a record high of 1.56 in May 2016, and its P/E of 26.4 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. Materials and Utilities both had their forecasted 2017 margin improve 0.1ppt w/w. 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 (18.6, 25.3), Financials (15.6, 14.3), Telecom (11.4, 11.2), Utilities (11.1, 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 (7.4, 7.2), Consumer Staples (6.5, 6.4), and Energy (3.9, 1.1).

US ECONOMIC INDICATORS

Regional M-PMIs >(*link*): Three Fed districts so far have reported on manufacturing activity for this month—New York, Philadelphia, and Richmond—and they show growth in the sector improved after slowing in July. We average the composite, orders, and employment measures as data become available. The composite index reversed July's slowdown, rebounding to 19.4 from 14.4 in July; it was at 27.0 in February—which was the highest reading since May 2004. The New York (to 25.2 from 9.8) measure accelerated sharply this month, recording its best growth in orders since September 2014, while Philadelphia's (18.9 from 19.5) continued to expand at a robust pace; Richmond's (14) matched July's healthy rate. The new orders gauge also made a roundtrip, expanding from 11.1 in July to 19.3 this month as billings in both the New York (20.6 from 13.3) and Philadelphia (20.4 from 2.1) districts accelerated sharply—with the former's back near March's cyclical peak of 21.3, while Richmond's (17 from 18) grew around July's robust pace. The employment measure accelerated to 11.1 after slowing steadily from March's cyclical high of 14.8 to 8.3 last month, led by a sharp pickup in hiring in the Richmond (17 from 10) district. Philadelphia (10.1 from 10.9) manufacturers continued to expand payrolls at a solid pace, while New York's (6.2 from 3.9) added to payrolls at a slightly faster pace this month, after slowing to a five-month low in July.

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