MORNING BRIEFING
September 19, 2017

On the Margins

See the collection of the individual charts linked below.

(1) Contrary to the bearish script. (2) Still waiting for the first part of the boom-bust cycle. (3) S&P 500 profit margin at record high. (4) NIPA profit margin is down, but a long way from reverting to the mean. (5) The Trauma of 2008 explains a lot. (6) Containing costs remains a top priority. (7) Disruptive technologies posing existential threats. (8) Forward profit margins of S&P 500 and its 11 sectors all exceed S&P 400/600 comparable series. (9) It's good to be big. (10). It's good to have a global business.

Strategy I: Refusing To Revert. The S&P 500 stock price index hasn't been following the script of the bears during the current bull market. Admittedly, there aren't too many left, which is something for contrarians to worry about. When the bears were more numerous and growling more loudly, one of their predictions was that the profit margin would "revert to the mean." It usually starts doing so during booms when corporations ramp up spending on labor and capacity expansion faster than revenues, which squeezes margins. Booms are inevitably followed by busts, which is when the profit margin reverts to the mean and falls below it, so that it can revert back up to the mean and surpass it during the inevitable recovery.

So far, this boom-bust narrative hasn't played out as it did during previous business cycles. Joe and I believe that's because corporate managements were traumatized by the Trauma of 2008, and have been very conservative ever since. In addition, most of them are facing intense pressures from disruptive technologies that pose existential threats to their business models. No wonder that they might be obsessed with maintaining as high a profit margin as possible. It has been different this time—so far. Consider the following:

(1) The S&P 500 profit margin rose to 10.8% during Q2, the highest on record. Okay, the record only starts with Q1-1993 (*Fig. 1*). However, this measure is highly correlated with the ratio of after-tax book profits of all corporations in the US divided by nominal GDP, which are data included in the National Income & Product Accounts (NIPA). By this measure, the profit margin peaked at a record high of 10.8% during Q1-2012, and was down to 9.3% during Q2-2017.

Nevertheless, it remains well above almost all previous cyclical peaks. Besides, we put more weight on the S&P 500 profit margin because that's a key variable in determining the profitability of the widely followed S&P 500 index.

(2) The NIPA profit margin that we just related to the S&P 500 profit margin has tended to peak during the booms at the tail ends of business cycles. Debbie and I have found that these peaks, which marked the beginning of the margin reverting to the mean, coincided with business costs rising rapidly relative to GDP (*Fig. 2*).

(3) Business costs are compensation of employees plus private nonresidential fixed investment spending as measured in the NIPA (*Fig. 3* and *Fig. 4*). The sum of the two as a percentage of GDP fell to a cyclical low of 64.0% during Q1-2010, which was the lowest reading since Q1-1955. It was back up to 66.0% during Q2-2017, which remains below the previous four cyclical troughs!

Strategy II: Margin Differences. In last Wednesday's *Morning Briefing*, Joe and I noted that the forward revenues and the forward earnings of the S&P 500/400/600 were continuing to trend higher in record-high territory (*Fig. 5* and *Fig. 6*). We also observed that the forward profit margin for the S&P 500 LargeCaps has been rising to new highs since early 2016, reaching 11.1% during the first week of September (*Fig. 7*). The forward profit margin for the S&P 400 MidCaps also has moved higher since early last year, to 6.7%, matching previous cyclical highs since 2008. This all makes sense to us.

The oddity is the forward profit margin of the S&P 600 SmallCaps. It's down from a cyclical high of 6.1% during October 2013 to 4.9% currently. Despite the margin erosion over the past four years, the S&P 600 is up 30.8% over this period, outpacing the S&P 500 (26.0%) and S&P 400 (23.9%) (*Fig. 8*).

We said we'd investigate further. A few clients were interested in seeing the margins for the 11 S&P sectors and asked whether the marked difference in profit margins was caused by different sector weightings across the three indexes. I asked Joe to have a look. Here is what he found:

(1) *LargeCaps beating SmallCaps across all sectors*. The marked difference in forward profit margins was not due to sector market-cap weighting differences across the three indexes. Looking at the latest forward profit margin data through the week of September 7, the S&P 500's margins are higher than those of the S&P 400 and the S&P 600 for ALL 11 sectors (*Fig. 9*).

The S&P 400's profit margin is higher than the S&P 600's for all sectors except Tech and Telecom. Furthermore, looking at the data back to 2006, we can see that LargeCaps and most of their sectors have consistently had a profit margin advantage over MidCaps and also the SmallCaps.

Here's how the sectors stacked up as of September 7: Tech sector (20.6% LargeCaps, 6.9% MidCaps, 7.1% SmallCaps), Real Estate (17.6, 13.9, 12.6), Financials (16.5, 14.8, 14.6), Telecom (11.4, -1.5, 3.5), Utilities (11.3, 10.3, 10.2), S&P 500/400/600 (11.1, 6.7, 4.9), Health Care (10.7, 6.4, 3.3), Materials (10.3, 6.5, 4.5), Industrials (9.6, 6.1, 4.3), Consumer Discretionary (7.6, 5.6, 3.2), Consumer Staples (6.8, 4.3, 2.5), and Energy (4.8, 0.4, 0.0).

(2) *Why are LargeCaps more profitable?* In our opinion, the S&P 500 companies got that big by being more successful and better managed over the long term than their peers. By virtue of their size, LargeCaps have a better chance of maintaining their dominant profitability. A wider product line, better customer support, and a larger client base help to minimize the effect that any missteps would have on revenues and profits.

They also have greater bargaining power when it comes to controlling costs and squeezing suppliers. That goes for health care costs too. Plus, LargeCaps can afford to hire the best lawyers to defend their patents and lobbyists to help craft legislation that is beneficial for their business. They also hire accountants to help shelter their overseas earnings from the IRS. In all likelihood, LargeCap companies have a lower effective tax rate since they do more business outside the US than the SMidCaps. In addition, their overseas operations are able to reap benefits from less regulation and lower labor costs in other countries relative to the US.

The statuary corporate tax rate has been 35.0% since 1993 (*Fig. 10*). The effective tax rate for all corporations was actually 21.2% during Q2-2017, according to the NIPA. However, that's skewed downward by companies that are losing money now, or profitable ones that are taking deductions for losses incurred during prior periods.

For the S&P 500, the effective rate was 26.4% during 2016 (*Fig. 11*). Odds are that the average S&P

400/600 company has a higher effective tax rate. A 2016 CNBC article hypothesized that the primary reason for this is because smaller companies tend to be more domestically focused than larger ones.

(3) *Some sectors are more equal than others*. The forward margin spread is 6.2ppts between the S&P 500 (11.1%) and the S&P 600 (4.9%). What's interesting is that the comparable spread for Utilities in those two indexes is only 1.1ppts (11.3% vs. 10.2%). What differentiates Utilities from the other sectors is that it is heavily regulated and its business activity is primarily concentrated in the US, so the LargeCap Utilities sector does not enjoy the advantages and tax benefits of having substantial overseas operations. The same could be said of the Financials sector, with a spread of only 1.9ppts (16.5% vs. 14.6%).

(4) *Drags on the S&P 600 margin.* A closer look at the S&P 600 sectors over the past four years shows that the Consumer Discretionary sector's forward profits margin weighed down the index as it declined from 4.3% to 3.2% in a fairly linear fashion. Consumer Staples was down from 4.2% to 2.5% over this period, in a more irregular downward trend. Health Care has been surprisingly weak over the past year, falling from 5.5% to 3.3%.

(5) *Lifting the S&P 500 margin.* In the S&P 500, the profit margins of the Consumer Staples and Health Care sectors have been remarkably stable since the start of the data in 2006. The former has been meandering around 6.5% since then, with a current reading of 6.8%. The latter has been meandering around 10.0% over this period with a current reading of 10.7%.

The S&P 500 sector with the highest profit margin is Information Technology. It is currently at 20.6% and has been slowly and steadily rising in recent years to new record highs. Also boosting the S&P 500's profit margin this year have been Financials (16.5% currently), Industrials (9.6), Real Estate (17.6), and Utilities (11.3).

(6) *Not much happening to S&P 400 margins.* The S&P 400 MidCap sectors tend to have profit margins that are closer to the ones for the SmallCaps than for the LargeCaps. Among the MidCap sectors, two have been trending higher in recent years, namely Financials and Utilities. Flat trends have been discernible in the following: Consumer Discretionary, Consumer Staples, Health Care, Industrials, Information Technology, and Materials.

CALENDARS

US. Tues: Housing Starts & Building Permits 1.173mu/1.220mu, Import & Export Prices 0.3%/0.2%, Current Account Balance, FOMC Meeting Begins. **Wed:** Existing Home Sales 5.48mu, MBA Mortgage Applications, EIA Petroleum Status Report, FOMC Announcement 1.125%. (Bloomberg estimates)

Global. Tues: Germany ZEW Economic Sentiment 12, Japan Merchandise Trade Balance, RBA Meeting Minutes. **Wed:** UK Retail Sales 0.0%m/m/1.4%y/y, Lowe. (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—sank 5.2% during the two weeks ending September 9 (after a seven-week surge of 5.0% to a new record high) driven by a hurricane-related jump in jobless claims. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). Our BBB tumbled 8.3% over the two-week period, following a seven-week jump of 5.5% to a new record high, as jobless claims spiked to a 13-month high of 263,250 (4-wa). Claims were at 236,750 two weeks ago, not far from late May's 235,500—which was the lowest since April 1973. The CRB raw industrial spot price index—another BBB component—continued to move down from recent highs. Meanwhile, the WCCI slipped 2.6% the past two weeks, after climbing by a total of 13.4% the prior seven weeks to a new cyclical high.

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose to a record high last week for LargeCap and MidCap; SmallCap's rose too, but remained 0.4% below its mid-July record. Momentum remains strong as the yearly change in forward earnings is up from six-year lows in early 2016, but the easy y/y comparisons may be waning. In the latest week, LargeCap's forward earnings was steady w/w at 9.5% y/y, which compares to a 64-month high of 10.2% in mid-May and a six-year low of -1.8% in October 2015; MidCap's was steady at 13.2% y/y, which compares to a 66-month high of 14.0% in early August and a six-year low of -1.3% in December 2015; and SmallCap's dropped to a nine-month low of 9.4% from 9.5%, which compares to a 39-month high of 13.0% in mid-July and a six-year low of 0.3% in December 2015. LargeCap's consensus growth rates expected for 2017 have remained strong throughout this year instead of falling. However, 2018 should improve if the corporate tax rate changes. Here are the latest consensus earnings growth rates: LargeCap 11.2% and 11.0%, MidCap 11.3% and 13.2%, and SmallCap 5.6% and 20.4%.

S&P 500/400/600 Forward Valuation (*link*): Forward P/E ratios fell 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 are easing now after melting 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 improved to a seven-week high of 17.7 from 17.4, and compares to 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 Tech bubble's record high of 25.7 in July 1999. MidCap's forward P/E rose to a six-week high of 17.7 from 17.3, and is not higher than LargeCap's P/E for only the second time since 2009. MidCap's P/E, which compares to a 15-year high of 19.2 in late February and the record high of 20.6 in January 2002, and is up from a three-year low of 15.0 in January 2016. SmallCap's rose to a seven-week high of 19.2 from 18.7, which compares to a recent high of 19.7 in early June and 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, but down 2.5 points from SmallCap's record-high P/E of 20.9 in April 2002. Looking at their forward price/sales (P/S) ratios, valuations last week were similarly higher for the three indexes: LargeCap's P/S of 1.97 matches the record high of 1.97 in late July; MidCap's 1.25 is down from a record high of 1.39 in early March, and SmallCap's 0.97 is down from 1.08 in early March and its record high of 1.17 in November 2013.

US ECONOMIC INDICATORS

Industrial Production (*link*): Hurricane Harvey reduced both the headline and manufacturing production measures by 0.75ppt in August, with the former dropping 0.9%—the most in eight years—and the latter sinking 0.3%. Excluding the hurricane-effect, headline production slipped 0.2%, while manufacturing output rose 0.5%. Headline production had increased in each of the prior six months by a total of 2.2%, while factory output remains volatile around recent highs. The largest estimated storm-related effects for manufacturing last month came from petroleum refining, organic chemicals, and plastics, materials & resins. Even including the hurricane effect, factory output was up 1.5% y/y, near April's 27-month high of 1.8%; headline production was 1.6% above a year ago, down from July's peak rate of 2.4%.

Capacity Utilization (*link*): The headline capacity utilization rate in August slipped to 76.1% from 76.9% in July—which was the highest since April 2015. It's 3.8ppts below its long-run (1972-2016) average. Manufacturing's capacity utilization rate fell to a five-month low of 75.3% from 75.6% the previous two months, 3.1ppts below its long-run average. Hurricane Harvey interrupted a long string of gains in the mining capacity utilization rate, pushing it down 0.9ppt to 83.9%, while the utilities capacity utilization rate sank 4.3ppts to 73.9%. Rates for both industries remained considerably below their long-run averages.

GLOBAL ECONOMIC INDICATORS

World CPI (*link*): Global consumer inflation continued to slow, falling a full percentage point from its recent peak of 3.7% y/y at the start of the year to 2.7% in June—its lowest reading since September 2015. World inflation has been trending lower since peaking at 5.2% in September 2011. The rate for advanced economies has slowed the past few months to 1.4% y/y in June after accelerating from 0.1% in September 2015 to 2.0% in February of this year, which was the highest since April 2012. May's inflation rate for emerging economies slowed to 4.8% y/y, down from its recent peak of 6.0% in mid-2016, and the lowest since November 2014.

US CPI (*link*): The core CPI rate in August was at 1.7% for the fourth month, below the Fed's target rate of 2.0% y/y for the fifth month, after 15 months above—ranging from 2.1% to 2.3%—from December 2015 through February of this year. The three-month rate accelerated for the third month to 1.9% (saar) after no change in May, which was the lowest reading in seven years. On a monthly basis, core prices rose 0.2%, up from 0.1% in each of the prior four months. Among the indexes posting gains were shelter, medical care, motor vehicle insurance, and recreation, while airfares and used cars & trucks were among the decliners. The headline CPI jumped 0.4%—a seven-month high—after little change the previous three months. The yearly rate edged up for the second month to 1.9% after falling the prior four months from 2.7% to 1.6%.

Eurozone CPI (*link*): August's CPI rate was 1.5% y/y—matching the flash estimate—up from 1.3% the prior two months, though holding below the ECB's goal of just under 2.0%; April's 1.9% rate was in line with the ECB goal. Looking at the main components, energy (to 4.0% from 2.2% y/y) had the highest annual rate, continuing to accelerate from June's four-month low of 1.9%. Meanwhile, the yearly rates for the remaining components, services (1.6), food, alcohol & tobacco (1.4), and non-energy industrial goods (0.5) all matched their July readings. The core rate—which excludes energy, food, alcohol, and tobacco—held at 1.2%, which is the highest in nearly four years.

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