



MORNING BRIEFING

October 19, 2017

Path of Least Resistance

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

(1) Climb every mountain. (2) Stock prices rising day after day as forward earnings rises week after week. (3) Drug prices are too *d%\$!m* high, but CPI drug inflation rate has come down a lot. (4) Public health concern. (5) FDA approving drugs at faster pace. (6) Amazon's Rx. (7) Government struggling to manage health care.

Strategy: Slow Motion Melt-Up. The S&P 500 closed at 2139.56 on Election Day, November 8, 2016. On December 12, Joe and I predicted that the S&P 500 would rise to 2400-2500 by the end of 2017. On July 31 of this year, we wrote: "Our yearend target of 2400-2500 has been achieved way ahead of schedule. Now, as strategists, we are aiming for 2700 by the middle of next year, a four-fold increase since March 2009. Assuming a forward P/E of 18, we would need to see forward earnings climb to \$150 per share by the middle of next year, up about 7.4% from the latest reading in late July. That's realistic, in our estimation."

Here we are in late 2017 with the S&P 500 at 2559.36. It is up 19.6% since Election Day. Last week, S&P 500 forward earnings rose to a new record high of \$142.36 per share ([Fig. 1](#)). That's impressive considering that industry analysts have been slashing their earnings estimates for Q3-2017, which was hard hit by the hurricanes ([Fig. 2](#)). However, all of 2017 is increasingly irrelevant as forward earnings per share is rapidly converging to the consensus earnings estimate for next year, which is currently \$145.55. The 2018 consensus will become increasingly irrelevant next year as forward earnings converges with the estimate for 2019, which is currently \$159.09.

Meanwhile, the S&P 500 forward P/E is currently at 18.0 ([Fig. 3](#)). Our Blue Angels analysis shows stocks flying as forward earnings continues to climb to record highs almost every week since Election Day ([Fig. 4](#)). No wonder the market is up almost every day since then. There hasn't been one significant correction since early 2016.

Industry Focus: Pharma and Biotech. Earlier this week, President Donald Trump repeated his dissatisfaction with the high price of prescription drugs. It's one of the few subjects that can unify both Democrats and Republicans. The President certainly didn't mince his words.

According to a 10/16 Bloomberg [video](#), the President said: "Prescription drug prices are out of control. ... If you look at the same exact drug, by the same exact company, made in the same exact box and sold someplace else, sometimes it's a fraction of what we pay in this country. Meaning, as usual, the world is taking advantage of the United States. They are setting prices in other countries and we're not. The drug companies, frankly, are getting away with murder. And we want to bring our prices down to what other countries are paying. Or at least close and let the other countries pay more because they're setting such low prices that we're actually subsidizing other countries and that's just not going to happen anymore."

While it's hard not to sympathize with his outrage, it's also tough to pinpoint a solution unless the FDA wants to get into the business of setting prices. The President can pontificate, but there's no use in

investors' panicking about drug price legislation until a credible plan is put forth. Indeed, the government may not have to get directly involved since the commentary from the ultimate bully pulpit may already be having the desired effect. Consumer prices for prescription drugs have been rising much more modestly in recent months. The September CPI for prescription drug prices rose 1.4% y/y, the lowest rate since January 2014 ([Fig. 5](#)).

The pharmaceutical and biotech stock indexes barely flinched at President Trump's latest attack. The S&P 500 Biotechnology index is up 28.1% ytd through Tuesday's close ([Fig. 6](#)). The shares are down 2.1% relative to their all-time high hit in 2015. The gains in the S&P Pharmaceuticals index aren't quite as exuberant, at 13.2% ytd, but the index is also near all-time high levels that it has tried to top twice before over the past two years. If the index succeeds on its third attempt, it would be breaking out after more than two years of consolidation ([Fig. 7](#)). I asked Jackie to have a deeper look at some of the developments on the state and federal levels that may affect drug prices going forward. Here is her report:

(1) *FDA on the case.* New FDA Commissioner Scott Gottlieb—a Trump appointee—declared high drug prices a “public health concern” that the FDA should address. He is approaching the matter by fostering increased competition by speeding up the approval process for complex generic drugs. The goal is to make a more efficient generic drug development, review, and approval process.

Gottlieb appears ready to make other changes as well. In a 7/24 Bloomberg [interview](#) he said, “There are situations where ... branded drug companies are taking advantage of certain rules to prolong monopolies beyond the point in which Congress intended, and that's what I've called the 'gaming.' We want to have more generic drugs approved on the first cycle. That's not only going to get more competition into the market, it's also going to end what I call the opportunity for regulatory arbitrage where you see speculators come into the market and pick off a generic drug that might not face a lot of competition. Now they have a monopoly for themselves and they're able to jack up the price because our process itself isn't efficient. So, we're going to try to target those products.”

We noted in the 9/7 [Morning Briefing](#) that the pace of FDA new drug approvals has picked up this year, helping biotech stocks. Turns out, the FDA has also been speedier with generic drugs, [approving](#) an average of 763 applications in its fiscal year ending September, up from 651 last year and 494 in fiscal 2015. Already, those efforts may be having an effect: “Counterintuitively, that has served as an overall headwind for generic drug manufacturers. Speedier approvals boost competition and restrain manufacturers' pricing power. Shares of many generic drug makers have struggled this year, despite an overall strong market for stocks,” a 10/6 [WSJ article](#) explained.

(2) *States taking action.* Instead of waiting for the federal government to bring down drug prices, a number of states are jumping into the fray. Earlier this month, California passed a law that requires drug companies to explain large price increases. “The law requires pharmaceutical companies to notify insurers and government health plans at least 60 days before a planned price increase of more than 16 percent during a two-year period, and to explain the rationale for the increase. The information will be available on a government website,” reported a 10/9 Bloomberg [article](#). The practice will begin in January 2019. The industry is expected to attempt to block the legislation in the state courts.

California isn't alone. Nevada passed a law that “requires pharmacy benefit managers to reveal rebates they receive from insulin makers, how much of those rebates are passed on to insurers and what they keep for themselves,” a 9/13 Bloomberg [piece](#) explained. The price of Eli Lilly's Humalog insulin cost \$21 a vial when introduced in 1996, and today its list price is \$275. The Biotechnology Innovation Organization and the Pharmaceutical Research and Manufacturers of America responded by suing Nevada, saying the law “violates patent rights and jeopardizes trade secrets.”

Maryland has a law on its books to penalize drug companies that price-gouge. The state will investigate reports of “unconscionable” price increases for essential off-patent or generic drugs. The law doesn’t apply to drugs that still have patent protection. Violators will be fined up to \$10,000. The state “can also require a manufacturer or distributor to show its records and justify a price increase,” a Reuters [article](#) reported on 9/29. The law survived the generic drug industry trade group’s initial request for an injunction, but the trade group plans to appeal the court’s decision.

In New York, a law passed this year will limit what the state’s Medicaid program will pay for drugs. If companies don’t discount a drug’s price enough, the state will review whether the price is out of line with its value. Meanwhile in Vermont, officials are allowed to scrutinize up to 15 drugs with rising prices on which the state spends “significant healthcare dollars,” noted a 9/29 *Washington Post* [article](#).

(3) *Could Amazon cure all?* If there ever was an industry ripe for disruption, it’s pharmaceuticals. Its pricing is opaque, its distribution often involves multiple layers, and going to a drug store when you’re sick to pick up medicine seems so 1950s.

Have no fear: Amazon reportedly plans to jump into the market of selling drugs by 2019. David Larsen, a Leerink Partners analyst, said his calls with “industry experts suggest that Amazon ‘is in active discussions’ with midsize pharmacy benefit managers and possibly a larger player,” reported a 10/6 Bloomberg [article](#). Meanwhile, CNBC [disclosed](#) on 10/6 that an email from Amazon said it would decide before Thanksgiving whether to move into selling prescription drugs online. Needless to say, that hasn’t been good news for drug store retailers CVS and Walgreens. The S&P 500 Drug Retail stock price index has fallen 6.7% since 10/6 and is down 33.8% from its July 29, 2015 peak ([Fig. 8](#)). Its forward P/E has tumbled to 12.0 from 20.8 in July 2015, not far from the depressed levels of the recession ([Fig. 9](#)).

(4) *No fever here.* As noted above, despite the bluster from the White House, the rapid FDA generic drug approvals, and the approaching shadow of Amazon, biotech and pharma stocks continue to rally. The S&P Pharma industry is expected to grow earnings by 8.1% over the next 12 months, and the net earnings revisions have been increasingly positive over the last three months ([Fig. 10](#) and [Fig. 11](#)). Meanwhile, its forward P/E of 15.9 is below the broader market and low relative to the industry’s history ([Fig. 12](#)).

The S&P 500 Biotech industry has similar patterns. It’s expected to grow earnings by 5.4% over the next 12 months. Industry analysts see the bottom line accelerating, from a decline of 0.1% this year, to 6.5% growth in 2018 and 10.5% in 2019 ([Fig. 13](#)). Granted, that’s looking far into the future, but at least the future looks bright. Here too, net earnings revisions from analysts have been increasingly positive ([Fig. 14](#)). And with a forward P/E of 15.5, the industry remains less expensive now than it has been during most periods over the last 20 years ([Fig. 15](#)).

Managed Health Care: Negotiations Ongoing. Beware the tweet. Just when it looked like the President and Congress were inching toward a temporary fix to the Affordable Care Act (ACA), the President sent out a tweet on Wednesday that said he “can never support bailing out (insurance companies) who have made a fortune with O’Care.” The implication: He won’t support the bipartisan deal struck on Tuesday, supposedly with the President’s encouragement.

Confused? Let’s take a step back. Things heated up last week when President Trump announced his administration would immediately end billions in payments to insurance companies under the ACA. Congress never appropriated funds for the ACA payments and therefore, he contended, making the payments was unlawful.

At the same time, however, President Trump reportedly let it be known that he would support preserving the payments if a bipartisan deal being negotiated by Republican Senator Lamar Alexander and Democratic Senator Patty Murray could be struck. And—wouldn't you know?—less than a week later, the two senators reached a short-term deal that could be taken up by Congress.

Here's the 10/17 *WSJ* [explanation](#) of the plan: "Under the deal, Republicans would get changes that let states get speedier and more flexible federal waivers to the health law, as well as the ability of more people to sign up for bare-bone health plans with low premiums. Democrats would get restored funding for billions of dollars in insurer subsidies, funds that Mr. Trump proposed cutting this month." The funding would be set for two years. The deal would also make it easier for states to get federal waivers from the ACA law, granting them a faster review period and more room to experiment with different health care models.

President Trump reportedly called Senator Alexander on Wednesday morning. "He called me to say that, number one, he wanted to be encouraging about the bipartisan agreement that Sen. Murray and I announced yesterday. Number two, he intends to review it carefully to see if he wants to add anything to it. Number three, he is still for block grants sometime later, but he will focus on tax reform this year," according to a 10/18 *WSJ* [account](#).

And then the tweet happened. Despite the uncertainty and confusion, S&P 500 Managed Health Care stock index remains near all-time highs, albeit with a bit of whiplash in recent days ([Fig. 16](#)). The index climbed 3.7% Monday and Tuesday, making up for a 3.6% loss late last week. Industry shares were also bolstered by news Tuesday that member UnitedHealth Group was increasing its 2017 earnings-per-share expectation to \$10 up from a previous range of \$9.75 to \$9.90, even after its decision to exit the ACA market. It also announced that next year's earnings could grow by 13% to 16% if the ACA tax on health plans does not return next year. If the tax does return, it would reduce EPS by 75 cents.

The Managed Health Care industry has been amazingly resilient despite all the political haranguing. The industry's revenues are expected to climb 7.0% over the next 12 months, while earnings are thought to increase by 10.8% ([Fig. 17](#)). Net earnings revisions by analysts have been decidedly positive, and profit margins have improved after bottoming in early 2016 ([Fig. 18](#) and [Fig. 19](#)). The industry's forward P/E, at 17.3, is at the upper end of its traditional range, but it doesn't look overly stretched ([Fig. 20](#)). That said, the market has a glimpse of how the industry's shares will react without a deal. Let the horse-trading continue.

CALENDARS

US. Thurs: Leading Indicators 0.1%, Jobless Claims 240k, Philadelphia Fed Manufacturing Index 20.2, Weekly Consumer Comfort Index, EIA Natural Gas Report. **Fri:** Existing Home Sales 5.300mu, Baker-Hughes Rig Count, Yellen. (Bloomberg estimates)

Global. Thurs: UK Retail Sales 2.2% y/y, China GDP 1.7%q/q/6.8%y/y, China Retail Sales 10.2% y/y, China Industrial Production 6.4% y/y, Australia Employment Change & Unemployment Rate 15k/5.6%. **Fri:** Canada CPI 0.3%m/m/1.7%y/y, Canada Retail Sales 0.4%, Kuroda. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators ([link](#)): Our Bull/Bear Ratio (BBR) ticked down to 3.95 this week after climbing the previous four weeks from a 10-month low of 2.33 to a 30-month high of 4.00. Bullish sentiment was little changed at 60.0% this week after jumping 13.3ppts the prior four weeks from an

11-month low of 47.1% to 60.4%. Bearish sentiment also barely budged, inching up to 15.2% after falling the prior four weeks from a post-election high of 20.2% to 15.1%, holding below the narrow 16.5%-18.3% range shown most of this year. The correction count was little changed as well this week, edging up to 24.8% after sliding 8.2ppts the prior four weeks from 32.7% to 24.5%. The AAll Ratio rebounded to 59.7% last week after slipping the previous three weeks from a 10-month high of 65.3% to 52.0%. Bullish sentiment climbed for the second week to 39.8% after a two-week decline from 41.3% to 33.3%, while bearish sentiment sank to 26.9% after rising from 22.0% to 32.8% the prior three weeks.

S&P 500 Earnings, Revenues & Valuation ([link](#)): Last week saw S&P 500 consensus forward revenues and earnings rise to new record highs. The forward profit margin forecast was steady at a record high of 11.1%, which 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 ticked up to 5.4% from 5.3%. That's 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 improved to a nine-month high of 11.5% from 11.3%. That compares to January's 11.7%, which was the highest since October 2011 and 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, and Tech. 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 5.2% is only 0.2ppts lower and STEG of 10.2% is 1.1ppts lower. The S&P 500 ex-Energy forward profit margin was steady w/w at a record high of 11.7%, which is its first since August 2007. The forward P/E rose to 18.1, which is the highest since February 2004 and compares to a 15-month low of 14.9 in January 2016. The S&P 500 price-to-sales ratio rose to a record high of 2.01 from 1.99, and was also at a record high of 2.07 on an ex-Energy basis. On an ex-Energy basis, the forward P/E of 17.7 is also the highest since February 2004.

S&P 500 Sectors Earnings, Revenues & Valuation ([link](#)): Consensus forward revenue forecasts rose last week for 8/11 sectors, but forward earnings rose for only three. 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 and earnings are ticking higher now, but remain near their lowest levels since the spring of 2017. The forward P/S and P/E ratios mostly rose w/w for the 11 sectors, but these three had both measures decline: Energy, Health Care, and Telecom. Health Care's P/E of 16.7 and P/S of 1.78 are down a tick from their 25-month highs in mid-September, and remain below their early 2015 highs of 17.9 and 1.88, respectively. Financials' P/E is up from 12.0 before the election to 14.4, 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 1.36 compares to a record high of 1.56 in May 2016, and its P/E of 27.8 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 typically improves as the year progresses when gains on property sales are included in the forecasts. In the latest week, the forecasted forward profit margin edged up 0.1ppt for Energy and ticked down the same amount for Financials. Here's how they rank based on their current 2017 forecasts: Information Technology (to 20.0% in 2017 from 19.2% in 2016), Real Estate (18.3, 25.0), Financials (14.9, 14.3), Telecom (11.3, 11.2), Utilities (11.2, 11.5), S&P 500 (10.5, 10.1), Health Care (10.5, 10.3), Materials (9.7, 9.1), Industrials (9.1, 8.8), Consumer Discretionary (7.3, 7.2), Consumer Staples (6.5, 6.4), and Energy (3.9, 1.1).

S&P 500 Q3 Earnings Season Monitor ([link](#)): With over 10% of S&P 500 companies finished reporting Q3-2017 earnings and revenue results through midday Wednesday, their surprise and y/y growth results are mixed compared to the same point during the Q2 earnings season, but more

companies are reporting a positive surprise. Of the 52 companies in the S&P 500 that have reported, 83% exceeded industry analysts' earnings estimates by an average of 5.4%; they have averaged a y/y earnings gain of 14.5%. At the same point during the Q2-2017 reporting period, a lower percentage of companies (78%) in the S&P 500 had beaten consensus earnings estimates by a lower 5.7%, and earnings were up a higher 36.0% y/y. On the revenue side, 73% beat sales estimates so far, with results coming in 1.2% above forecast and 6.9% higher than a year earlier. At this point in the Q2 season, a lower 70% had exceeded revenue forecasts by a slightly higher 1.3%, and sales rose a lower 5.2% y/y. Q3 earnings results are higher for 85% of companies, vs 72% at the same point in Q2, and revenues also are higher for 85%, vs 87% a quarter ago. Although these figures will change markedly as more Q3-2017 results are reported in the coming weeks, particularly the insurers, the early results are encouraging. Q3-2017 should mark the fifth straight quarter of positive y/y earnings growth despite the negative impact of the three hurricanes. However, growth is likely to fall back into the low single digits following double-digit percentage growth in Q1 and Q2, which was the first double-digit growth seen since Q3-2011.

US ECONOMIC INDICATORS

Housing Starts & Building Permits ([link](#)): Homebuilders in September broke ground on fewer homes for the sixth time in seven months, hindered by shortages of skilled labor and lots, along with rising materials' costs—with hurricanes joining the mix in September. Starts sank 4.7% last month and 12.5% over the seven-month period to a one-year low of 1.127mu (saar), as multi-family starts dropped 5.1% and 27.5% over the comparable periods to a 12-month low of 298,000 units (saar). Single-family starts tumbled 4.6% last month to 829,000 units (saar) as starts down South tumbled a hurricane-related 15.3%. Single-family starts had increased two of the previous three months by 9.3%. Building permits slumped 4.5% to a four-month low of 1.215mu (saar) in September, after climbing two of the prior three months by 8.9%. Single-family permits advanced for the third time in four months by 2.4% m/m and 5.1% over the period to a six-month high 819,000 units (saar). Volatile multi-family permits plunged 16.1% to 396,000 units (saar) after a 12.9% jump and a 9.9% drop the previous two months. Looking ahead, homebuilders' confidence returned to the high 60s this month, rebounding 4 points to 68, following September's hurricane-related fall. NAHB's Chairman Granger MacDonald noted the rebound in confidence from the "initial shock of the hurricanes" but warned "that builders need to be mindful of long-term repercussions from the storms, such as intensified material price increases and labor shortages."

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