



## MORNING BRIEFING

November 27, 2017

### High Flyers

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

(1) Looking for froth. (2) Breadth indicators showing broad-based advance. (3) Analysts turning even more bullish on S&P 500 revenues, and see double-digit earnings growth this year and next two years. (4) Revenues and earnings are flying for the high-flying Magnificent 10 of the S&P 500. (5) Six Republican senators are on the fence. Trump needs four of them to pass tax reform. (6) What do the six fence sitters want?

**Strategy I: Hard-Charging Bull.** Before we left for our Thanksgiving break, Joe and I had a closer look at this year's bull market through Monday of last week. We wanted to see if the 10 leading industries so far this year are showing frothiness, thus confirming that a meltup might be underway. To cut to the chase, we found that the 15.3% rise in the S&P 500 through 11/20 has been supported by solid fundamentals for both the overall market as well as most of the top 10 hard-charging industries leading this year's stampede. In other words, so far so good as far as we are concerned. Let's have a closer look at the market:

(1) *Lots of industries advancing.* Of the 124 S&P 500 industries we track, 53 have been beating the S&P 500 ([Table 1](#)). On the other hand, of the 71 that are underperforming the S&P 500, 38 are actually down for the year. The losers include retailers, energy companies, telecoms, and consumer staples companies. The winners are mostly in the IT, Health Care, Materials, and Consumer Discretionary sectors.

(2) *Broad advance.* The ratio of the S&P 500 to the S&P 100 stock price indexes has been on a slight uptrend this year, confirming that the market advance is broad-based ([Fig. 1](#)). As of the 11/17 week, the percentage of S&P 500 companies with positive y/y comparisons was 74.3% ([Fig. 2](#)). The percentage of S&P 500 companies trading above their 200-day moving averages was 66.3% as of the 11/17 week ([Fig. 3](#)). The NYSE advance/decline line has been rising to new record highs along with the NYSE composite index ([Fig. 4](#)).

(3) *Solid fundamentals.* Over the past couple of weeks through the 11/16 week, industry analysts have been raising their S&P 500 revenue estimates for both 2018 and 2019 ([Fig. 5](#)). They now expect that revenues will grow 6.1% this year, then 5.4% and 4.9% during 2018 and 2019, respectively. As a result, S&P 500 forward revenues continues to set new record highs, and seems to have been doing so at a faster pace over the past couple of weeks. Not surprisingly, the same can be said of S&P 500 earnings, as the forward profit margin rose to a record 11.1% during the 11/16 week. Industry analysts are currently forecasting that S&P 500 earnings will rise 10.8% this year, and 11.3% and 10.1% over the coming two years.

**Strategy II: Magnificent 10.** And the S&P 500 industry winners are (on a ytd basis, through 11/20): Semiconductor Equipment (75.9%); Casinos & Gaming (65.8); Homebuilding (62.9); Application Software (58.2); Home Entertainment Software (57.5); Health Care Supplies (49.3); Auto Parts & Equipment (45.9); Life Sciences Tools & Services (45.4); Internet & Direct Marketing Retail (43.8); and Technology Hardware, Storage, & Peripherals (43.5). Let's look at the fundamentals of some of these

S&P 500 high-flying industries:

(1) *Semiconductor Equipment*. The forward earnings of this industry has soared by 64.7% y/y through the 11/16 week ([Fig. 6](#)). Industry analysts are expecting earnings to grow 65.7% this year and 24.2% and 7.0% over the next two years. As a result of the remarkable jump in forward earnings yield, the forward P/E remains very reasonable at 14.4 ([Fig. 7](#)).

(2) *Homebuilding*. The forward earnings of this industry is up 22.7% y/y ([Fig. 8](#)). The forward P/E was 12.9 during the 11/16 week. Industry analysts are projecting earnings growth rates of 10.3% this year, 26.0% during 2018, and 10.7% during 2019.

(3) *Application Software*. The forward earnings of this sector remains below its highs of the late 1990s, but it is up 34.0% y/y ([Fig. 9](#)). This has been a high-priced industry since 2014, with the forward P/E stable around 35.0. But industry analysts are projecting double-digit earnings growth rates of 21.1% this year, and 25.8% and 22.9% over the next two years.

(4) *Internet & Direct Marketing Retail*. This industry is in the Consumer Discretionary sector and has several high flyers (AMZN, EXPE, NFLX, PCLN, and TRIP). It's certainly one of the frothier industries in the S&P 500, as forward earnings has actually stalled, albeit at a record high, while the forward P/E rose from 51.9 a year ago to 72.1 during the 11/16 week ([Fig. 10](#)). On the other hand, the industry's forward revenues has been flying to new highs ([Fig. 11](#)). Industry analysts are predicting the following combinations of revenues and earnings growth rates for 2017 (28.3%, 8.7%), 2018 (26.7, 36.8), and 2019 (19.8, 40.5).

(5) *Technology Hardware, Storage & Peripherals*. The forward earnings of this industry, which includes Apple (AAPL, HPE, HPQ, NTAP, STX, WDC, and XRX), is up 24.9% y/y to a new record high ([Fig. 12](#)). Yet it remains relatively cheap, with a forward P/E of 13.9 ([Fig. 13](#)).

**US Tax Reform: Counting Fence Sitters.** Thirteen Republicans voted against the bill. Twelve of them are from states with high taxes, [observed](#) the 11/16 *WSJ*. To pass the Senate's alternate version of the tax bill in the full Senate, the GOP can't lose more than two of the potential 52 votes; no Democrats are expected to support the bill.

For now, the Senate bill is moving forward. Members of the Senate Finance Committee voted 14 to 12 in favor of their version of the tax plan also on 11/16. The bill will be brought to a vote in the full Senate as soon as this week. The next step will be to get the bill into a [conference committee](#) to reconcile the House and Senate plans sometime in early December, as explained the *WSJ*'s Gerald Seib in an 11/16 [video](#).

Both the Senate vote and the reconciliation process could prove challenging for the bill's passage. Any amendments to the Senate plan geared to please those senators who haven't proclaimed support for the bill yet would require tweaking other parts of the plan. That's because the budget process set a ceiling of \$1.5 trillion in cuts over the next decade. (For more, see our 11/15 [Morning Briefing](#)).

In an 11/19 [interview](#) with the *WSJ*, Vice President Mike Pence was asked whether he believed the Senate bill had enough votes to move forward, especially given the uncertainty around the 12/12 Alabama Senate race. Pence responded: "We believe we'll have the votes. ... But we're taking nothing for granted."

So far, about a half-dozen GOP senators have taken issue with provisions in the Senate plan. Lots of press stories have hyped these senators' opposition to the tax bills. But listening closely to some of

their comments, Melissa and I think that there's a decent chance that their concerns will be ironed out through the legislative process. Let's have a look at what beefs these GOP senators on the fence have with the post-Turkey Day bill:

(1) *Sen. Ron Johnson (concern: insufficient pass-through provisions)*. Johnson was the first GOP senator to voice opposition to the Senate plan, reported the media headlines during mid-November. The Wisconsin senator is primarily concerned that the cuts for small businesses, particularly pass-throughs, aren't as generous as the earlier White House tax reform framework suggested. However, according to an 11/20 Bloomberg [article](#), Johnson is expected to vote "yes" at the end of the process. Recently, he said: "I'm encouraged by the information and the cooperation I'm getting right now" from the tax writers in the Senate Finance Committee.

(2) *Sen. Bob Corker (concern: adding to the debt)*. Corker technically can vote either way without any political pressure, as he has [announced](#) that he is retiring after 2018. The senator from Tennessee told NBC's Chuck Todd on 10/1 that he wouldn't support a tax reform plan that adds "one penny to the deficit." But Corker's tone was softer on 10/26 when he [told](#) CNBC: "If we do it right, and we do the corporate things we're talking about, I'll believe we'll get the dynamic score that is necessary" so as not to balloon the deficit.

(3) *Sen. Jeff Flake (concern: adding to the debt)*. Like Corker, Flake recently [announced](#) that he will not seek reelection in the next cycle. And currently, Flake is engaged in a social media feud with the President, but he said that won't impact his decision, [according](#) to Reuters. In an 11/9 [statement](#), Flake said: "I remain concerned over how the current tax reform proposals will grow the already staggering national debt by opting for short-term fixes while ignoring long-term problems for taxpayers and the economy." But he added: "I look forward to working with my colleagues to deliver on the goal of crafting tax reform in "a fiscally responsible manner."

(4) *Sen. Susan Collins (concern: repealing the healthcare mandate)*. Maine's Collins didn't say she would vote "no" on the Senate bill in an 11/19 [interview](#) on CNN. But she did express specific opposition to the late introduction of the provision to repeal the individual healthcare mandate in the Senate bill. Even so, she said she expects the bill to be amended from its current form and hopes that the Senate bill will follow the lead of the House in excluding healthcare as well as a couple of other provisions.

(5) *Sen. Lisa Murkowski (concern: repealing the healthcare mandate)*. CNN covered Murkowski's interesting position on 11/20 in an [article](#) titled: "Lisa Murkowski saved Obamacare. But here's why she may not abandon Republicans on taxes." Murkowski is not pleased that the debate about the individual mandate has made its way into tax reform. On the other hand, CNN observed that the tax plan will be combined with a bill that is important to the senator from Alaska. It would permit oil and gas drilling in Alaska's Arctic National Wildlife Refuge (ANWR). Murkowski chairs the committee that was previously chaired, from 1995 to 2001, by her father, who had unsuccessfully tried to open ANWR for drilling.

(6) *Sen. John McCain (concern: defense spending)*. The Arizona senator views the tax bill favorably so far, the 11/17 *WSJ* [observed](#). But as chairman of the Armed Services Committee, McCain is pushing to ensure that the military gets its fair share for the rest of this year. However, he hasn't yet "drawn a direct connection between the two issues."

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