Lesson Learned in 2018

See the collection of the individual charts linked below.

(1) A show of hands in Charlotte. (2) Bull-Bear Ratio so low it’s bullish. (3) Are the bears satisfied, or do they want more? (4) 1987: Déjà vu all over again. (5) No recession in the wings. (6) Volatility confirms that stocks should be held for the long run rather than traded in the short run. (7) Earnings growth this year weighed down by unbeatable earnings growth last year. (8) Industry analysts lowering their earnings growth rates for this year, though revenues growth expectations firming. (9) Profit margins have peaked. (10) Valuation multiples are cheap. (11) Movie: “On the Basis of Sex” (+ +).

Strategy I: Sentimental Journey. I was the headliner at the annual North Carolina CFA forecasting dinner last Wednesday in Charlotte. There were over 350 people in the room. I asked them to raise their hands if they were bullish, and then if they were bearish. To me, it seemed like 35% were bullish, 25% were bearish, and the rest chose not to raise their hands.

A much better sentiment survey is the weekly one of market commentators conducted by Investors Intelligence. Debbie and I track the survey’s bull-to-bear ratio (BBR). It hit a near-record high of 5.25 during the week of January 16, 2018 (Fig. 1). The S&P 500 peaked at a then-record high of 2872.87 on January 26 (Fig. 2).

That was followed by a 10.2% correction in the S&P 500 lasting 13 days. The index proceeded to make an all-time record high of 2930.75 on September 20, with the BBR down to 3.26. That was followed by a 19.8% correction lasting 95 days. The BBR plummeted to 0.86 during the 1/1 week and rebounded modestly to 1.18 last week. Both of the latest readings were the lowest since early 2016, which was a great buying opportunity. We’ve found that the BBR has provided a very good buy signal whenever it fell to 1.00 or less (Fig. 3). Apparently, it’s still working, since the S&P 500 is up 10.4% since it bottomed on Christmas Eve.

Strategy II: The Upside of 2018. I also asked the audience in Charlotte to raise their hands if they sold all their equities on September 20 and bought them back on December 24. No one raised a hand. Playing corrections, and even bear markets, isn’t so easy. Even if you pick the top in the bull market, you then have to pick the bottom in the correction or the bear market.

Then again, let’s give the bears some credit. They can rightly claim that they finally got their long-predicted bear market. While it remains in the record books as a correction rather than a bear market, it certainly felt like a bear market, with lots of industries and stocks down 20% or more. Indeed, of the 126 S&P 500 industries Joe and I track, 54 fell into bear-market territory from September 20 through December 24 (Table 1).

Yet from September 20 through this past Friday, the S&P 500 is down only 11.4%, with just 19 industries still in bear-market territory (Table 2). Since the December 24 low, the S&P 500 is up 10.4%, with 74 industries up as much or more (Table 3).
In many ways, the latest correction is reminiscent of the 1987 bear market. Back then, it was really a one-day flash crash that occurred on October 19. It was attributable to computer-driven selling by “portfolio insurance” algorithms. There was no recession. The economy and earnings continued to grow. The S&P 500 rose above its previous record high reached on August 25, 1987 on July 26, 1989 (Fig. 4). The current selloff was also exacerbated by algorithms. It certainly was volatile and felt like a flash crash during the final month of last year, which was the worst December since 1931 for stocks.

Meanwhile, as in 1987, there’s no solid evidence of an imminent or impending recession. The current GDPNow model estimate for real GDP growth in Q4-2018 remained at 2.8% on January 10. Payroll employment rose 254,000 per month, on average, during the final three months of 2018. Earnings growth is slowing rapidly, as Joe and I anticipated when we “curbed our enthusiasm” for stocks at the end of last October. But growth should remain positive in the low single digits.

I turned more enthusiastic on stocks the day after Christmas, noting in a CNBC interview that stocks were cheap and that the extraordinary rally that day suggested that “Investors are coming back to their senses. There was way too much fear driving this market.” I reiterated our S&P 500 target of 3100 for the end of 2019. (Of course, I also got the word out to our subscribers in 12/26 and 1/1 video podcasts during our holiday vacation.)

While 2018’s 9.6% gain through September 20 was turned into a 6.2% loss by the end of the year, perhaps we learned something important from last year’s volatility. As both Warren Buffett and Jeremy Siegel have often observed, stocks should be held for the long run. If algorithms are here to stay, they are likely to create more volatility, as was demonstrated last year—all the more reason for long-only investors to stay the course and avoid getting whipsawed. Most investors don’t complain about algos when stock prices are melting up. They only do so when stocks are melting down. However, those meltdowns create buying opportunities.

Then again, selling at the top and buying at the bottom is an achievement that neither humans nor computers are likely to score on a regular basis.

Strategy III: Yearnings Season. As Joe and I anticipated in late October, investors are likely to be yearning in 2019 for the double-digit earnings growth experienced last year. We curbed our enthusiasm for earnings growth back then because we noted that the S&P 500 profit margin had risen to a record high of 12.5% during Q3-2018 thanks to Trump’s corporate tax cut (Fig. 5). We doubt that it can go any higher anytime soon.

So earnings growth should equal revenues growth. The former could be weaker than the latter if the profit margin declines. If earnings growth stays positive in the low single digits (with the help of buybacks), then there is plenty of room for the stock market to move higher along with valuation multiples, which were beaten down during the latest correction. Remember: Instead of discounting last year’s extraordinary gain in earnings, investors chose to ignore it all by slashing multiples in anticipation of a recession that is a no-show so far. Let’s review the latest relevant data:

(1) Q3’s uninspiring earnings season. Industry analysts have been scrambling to slash their earnings estimate for Q4-2018 ever since they received cautious earnings guidance during October’s earnings season for Q3-2018 (Fig. 6). Interestingly, the actual result for that prior quarter turned out to be 5.0% better than analysts estimated at the start of the prior earnings season. Yet they’ve cut the Q4-2018 estimate by 4.0% since early October. Odds are that there will be another better-than-expected hook in earnings, as there often tends to be in this quarterly game.
In any event, analysts are also paring their estimates for earnings during each of this year’s four quarters (Fig. 7). So while they still expect a double-digit gain of 13.4% for the last quarter of 2018, it's all low-single-digit gains for the first three quarters of this year, at 5.3% (Q1), 4.8% (Q2), and 5.0% (Q3). A double-digit gain of 11.7% is currently expected during the final quarter of this year.

(2) Annual earnings estimates falling. According to the analysts’ consensus, last year’s S&P 500 operating earnings per share soared 22.7% to $162.00 (Fig. 8). Their 2019 and 2020 estimates are falling toward our forecasts of $170 this year and $179 next year. Their current estimates are $173.63 for this year and $192.96 for next year.

The consensus expected growth rate for this year peaked at 10.3% late last year and was down to 7.3% at the start of this year (Fig. 9). The 2020 consensus is up 10.8%. We are forecasting growth rates of 4.3% this year and 5.3% next year. (See YRI S&P 500 Earnings Forecasts.)

(3) Less sizzle in revenues. Industry analysts are estimating that S&P 500 revenues rose 8.8% y/y last year, the best performance since 2010 (Fig. 10). They are expecting less growth this year (6.4%) and next year (4.8%). However, both estimates have actually been rising in recent weeks!

(4) Peaking profit margins. We can use the analysts’ consensus earnings and revenues estimates to derive their implied profit margin expectations for the S&P 500 (Fig. 11). At the beginning of this year, their numbers showed that the margin rose to a record 12.0% for 2018. They are expecting even higher margins this year (12.1%) and next year (12.8%). However, both of these estimates have been falling since late last year. The forward profit margin peaked at a record 12.4% during the 9/13 week, and fell to 12.2% during the 1/3 week.

(5) Valuation’s upside. The forward P/E of the S&P 500 peaked last year at 18.6 on January 23 (Fig. 12). It troughed at 13.5 on December 24. On Friday, it was back up to 14.9. Joe and I believe that this multiple could move higher over the rest of this year. Inflation remains subdued. The Fed may be done raising interest rates for a while. The 10-year Treasury bond yield could remain just below 3.00%. China and the US are likely to hammer out a trade deal by the end of February. Brexit might not happen after all if another referendum is called. The price of oil could stabilize if the Saudis and Russians cut their exports. The dollar could ease a bit. The global economy could show some strength later this year in this scenario.

If so, then Panic Attack #62 was a correction, not a bear market. Whatever we call it, though, it was another great buying opportunity in this bull market.

Movie. “On the Basis of Sex” (+ +) (link) is an interesting, if formulaic, biopic about the life and times of Supreme Court Justice Ruth Bader Ginsburg. The film stars Felicity Jones in the title role of a young woman who excelled at Harvard Law School, but couldn’t find a job at a law firm. Instead, she accepted a teaching position at Rutgers. However, she teamed up with her husband, a prominent tax attorney, to bring a precedent-breaking case before the US Court of Appeals. They won their case, overturning a century of gender discrimination. The movie reminds us of the importance of the rule of law in America. When the rules become antiquated and even oppressive, it’s good to be reminded that there is a very civil legal process for adapting them to conform to our society’s changing needs. It may be a slow process, but it beats the alternatives of radical change.

**CALENDARS**

**US. Mon:** No indicators. **Tues:** PPI-FD Total, Core, and Core Ex Trade Services -0.1%/0.2%/0.2%, Empire State Manufacturing Index 12.0, George. (Econoday estimates)

STRATEGY INDICATORS

Global Stock Markets Performance (link): Last week saw the US MSCI index rise 2.6% w/w and rank 26th of the 49 global stock markets we follow in a week when 45/49 countries rose in US dollar terms. That compares to the prior week’s 29/49 ranking, when the US MSCI gained 1.9% and 41 markets rose. The AC World ex-US index rose 3.2% for its best gain in 10 weeks; that compares to a 1.2% rise a week earlier. EM Asia was the best performer with a gain of 4.0%, ahead of BRIC (3.5%). EMU was the worst performer, albeit with a gain of 2.1%. Also trailing the AC World ex-US index last week were EMEA (2.5), EM Eastern Europe (2.7), EAFE (2.8), and EM Latin America (2.9). Pakistan was the best-performing country, rising 6.4%, followed by Argentina (6.3), Singapore (5.7), China (5.1), and Taiwan (5.0). Of the 30 countries that underperformed the AC World ex-US MSCI last week, Sri Lanka fared the worst, falling 2.5%, followed by Egypt (-1.7), India (-0.3), and Jordan (-0.2). The US MSCI ranks 32/49 so far in 2019, with its 3.7% ytd gain slightly behind the AC World ex-US (4.0). All regions and all countries are in positive territory ytd. Among the regions, those outperforming the AC World ex-US include: EM Latin America (9.8), EM Eastern Europe (6.0), EMEA (4.6), and BRIC (4.4). Regions underperforming the AC World ex-US: EM Asia (2.3), EMU (3.4), and EAFE (3.9). The best country performers ytd: Argentina (11.6), Brazil (11.3), Colombia (9.4), Chile (7.8), Mexico (7.7), and Greece (7.7). The worst-performing countries so far in 2019: Sri Lanka (-3.2), Turkey (-2.2), India (-1.8), and Taiwan (-0.3).

S&P 1500/500/400/600 Performance (link): All of these indexes rose for a third straight week, but remain well below their record highs. LargeCap rose 2.5% last week, below than the gains for MidCap (4.7%) and SmallCap (4.6). LargeCap ended the week 11.4% below its record high on September 20, while MidCap and SmallCap are 14.0% and 17.9% below their August 29 records, respectively. All 33 sectors moved higher last week, a slight improvement from the week before when 30 rose. The biggest gainers in the latest week: MidCap Energy (8.3%), SmallCap Tech (6.3), MidCap Health Care (6.3), MidCap Tech (6.3), and SmallCap Real Estate (5.9). LargeCap Consumer Staples (0.6) was the smallest gainer last week, followed by LargeCap Utilities (0.8), SmallCap Utilities (1.0), and LargeCap Financials (1.0). In terms of 2019’s ytd performance, all three indexes are off to a great start: SmallCap (6.8), MidCap (6.0), and LargeCap (3.6). Thirty-two of the 33 sectors are positive ytd with Energy dominating the top performers: MidCap Energy (17.5), SmallCap Energy (16.7), SmallCap Communication Services (9.3), SmallCap Consumer Discretionary (8.6), SmallCap Materials (8.4), and LargeCap Energy (8.1). Utilities dominates the biggest underperformers so far in 2018: SmallCap Utilities (-0.8), MidCap Utilities (0.5), LargeCap Utilities (0.6), LargeCap Consumer Staples (1.6), and LargeCap Health Care (1.6).

S&P 500 Sectors and Industries Performance (link): All 11 of the sectors rose last week, and five outperformed the S&P 500’s 2.5% gain. That compares to nine rising a week earlier, when six outperformed the 1.9% gain for the S&P 500. Industrials was the best-performing sector with a gain of 4.1%, ahead of Real Estate (4.0%), Consumer Discretionary (3.7), Tech (3.4), and Energy (3.4). Consumer Staples (0.6) rose the least, followed by Utilities (0.8), Financials (1.0), Communication Services (2.1), and Health Care (2.3). All 11 sectors are also higher so far in 2019, compared to just two sectors rising during 2018 when the S&P 500 fell 6.2%. These five sectors are outperforming the S&P 500’s 3.6% rise ytd: Energy (8.1), Consumer Discretionary (6.0), Communication Services (6.0), and Industrials (5.4). 2019’s laggards, albeit with gains: Utilities (0.6), Consumer Staples (1.6), Health Care (1.6), Tech (2.5), Financials (2.7), Real Estate (3.2), and Materials (3.4).
Commodities Performance (link): Last week, the S&P GSCI index rose 4.2% for its biggest gain since mid-April as 16 of the 24 commodities moved higher. That compares to a 3.2% rise a week earlier, when 16 commodities moved higher. However, the index is still in a correction with a drop of 19.8% from its high in early October after being down as much as 26.9% on December 24. Last week’s strongest performers: Crude Oil (8.1%), GasOil (7.6), Lean Hogs (7.2), Sugar (7.1), and Brent Crude (6.2). Natural Gas was the biggest decliner with a drop of 2.2%, followed by Aluminum (-1.5), Corn (-1.2), and Soybeans (-1.2). The S&P GSCI commodities index is up 7.6% ytd following a decline of 15.4% in 2018. The top-performing commodities so far in 2019: Crude Oil (14.2%), Brent Crude (12.6), Heating Oil (11.6), GasOil (11.3), Lean Hogs (8.9), and Unleaded Gasoline (8.6). The biggest laggards in 2019: Cocoa (-2.5), Feeder Cattle (-1.3), Lead (-1.0), and Copper (-0.5).

S&P 500 Technical Indicators (link): The S&P 500 price index rose 2.5% last week, and improved relative to its short-term 50-day moving average (50-dma) and its long-term 200-day moving average (200-dma). However, the index’s 50-dma relative to its 200-dma fell for a 14th straight week, and was in a Death Cross for a sixth week; it had been in Golden Cross for 137 weeks. It was last in a Death Cross for 17 weeks through April 2016 when its 50-dma bottomed at a then-four-year low of 4.5% below its 200-dma in March 2016. The current Death Cross reading of -4.4% is the lowest since then; it’s down from -4.0% a week earlier and a 55-month high of 7.2% in February 2018. The S&P 500’s 50-dma fell for a 14th week following 19 straight weekly gains, which compares to declines during eight of the 10 weeks from mid-March to late May in what was then the worst performance since before the 2016 election. The index improved to 1.0% below its falling 50-dma from 3.9% below its falling 50-dma a week earlier and compares to a seven-year low of 12.0% below at the end of December. That’s down from a two-year high of 6.2% above its rising 50-dma on January 29. The 200-dma fell for a sixth straight week, but barely so. The 200-dma has dropped in 10 of the past 13 weeks in the first downtrend since May 2016, when it had been slowly declining for nine months. The S&P 500 fell to 5.3% below its falling 200-dma from 7.7% below a week earlier, but remains well below the seven-year high of 13.5% above its rising 200-dma during January 2018.

S&P 500 Sectors Technical Indicators (link): All 11 S&P 500 sectors improved last week relative to their 50-dmas and 200-dmas. Two of the 11 sectors traded above their 50-dmas, an improvement from a week earlier when all 11 were below. The longer-term picture—i.e., relative to 200-dmas—shows two sectors trading above currently, up from one a week earlier as Health Care moved above. When Utilities was the only sector above its 200-dma during December, that had been the lowest count since all 11 were below in January 2016, and was a relatively swift reversal from the September 26 alignment, when all 11 sectors were above their 200-dmas. Two long-term 200-dma leaders left the building during the recent correction: Tech fell below its 200-dma for the first time in 121 weeks, and Consumer Discretionary fell below its 200-dma for the first time in 102 weeks. Four sectors remain in the Golden Cross club (with 50-dmas higher than 200-dmas), unchanged from a week earlier: Health Care and Real Estate (27 straight weeks), Utilities (23), and Consumer Staples (18). At the end of November, Consumer Discretionary and Tech left the club for the first time since April 2016. Among the laggards, Financials has been out of Golden Cross territory for 13 straight weeks and during 25 of the past 29 weeks, Materials has been out for 37 straight weeks, Energy for nine weeks, and Industrials for eight weeks. All 11 sectors had been in a Golden Cross back in mid-January (for the first time since a 26-week streak ended in October 2016). Real Estate and Utilities are the only sectors with a rising 50-dma now, compared to a week earlier when Materials was the only member of that club. Four sectors had rising 200-dmas at the end of last week, up from two a week earlier in what was then the lowest count since January 2016 when all 11 sectors had falling 200-dmas. In the latest week, Consumer Discretionary and Real Estate joined Health Care and Utilities in the rising 200-dma club, and Tech stopped falling.

US ECONOMIC INDICATORS
**CPI** (link): December’s core CPI rate held above the Fed’s target rate of 2.0% y/y for the tenth straight month, though remained below July’s peak rate for the fifth month. Core prices rose 2.2% y/y in December, matching November’s pace—though once again was below July’s 2.4% rate—which was the fastest pace since September 2008. Here’s a ranking of the core goods rates, lowest to highest: Apparel (-0.1% y/y), new vehicles (-0.3), medical care commodities (-0.5), alcoholic beverages (1.8), used cars & trucks (1.4), tobacco & smoking products (3.4)—with only the last one surpassing the total core rate of 2.2%. Here’s the same exercise for the core services rates: Airfares (-2.6), physicians’ services (0.6), motor vehicle maintenance & repair (2.3), owners’ equivalent rent (3.2), rent of primary residence (3.5), hospital services (3.7), and motor vehicle insurance (4.6)—with only the rate for motor vehicle maintenance & repair on an accelerating trend. Core prices in December rose 0.2% for the third month, pushing the three-month rate up to 2.5% (saar)—the highest since March 2018—after slowing to a 15-month low of 1.6% in October. The headline CPI rate slowed to 1.9% y/y, the lowest since August 2017 and a percentage point below its recent high of 2.9% posted in both June and July, which was the highest since February 2012.

**GLOBAL ECONOMIC INDICATORS**

**UK GDP** (link): Economic growth in the UK accelerated in November, though the three-month rate slowed to a six-month low. Real GDP increased 0.2% in November, following a 0.1% gain in October and no growth in both August and September. During the month, manufacturing contracted -0.3%, while services and construction output accelerated 0.3% and 0.6%, respectively. On a rolling three-month basis, from September to November, real GDP increased 0.3%, slowing steadily from August’s 0.8%—which was the strongest since early 2017. The head of GDP at the ONS said: “Accountancy and housebuilding again grew but a number of other areas were sluggish. Manufacturing saw a steep decline, with car production and the often-erratic pharmaceutical industry both performing poorly.” Of the four industry groupings, services (unchanged at 0.3%)—which accounts for 80% of the UK economy—grew near its low for 2018, based on a rolling three-month basis. Meanwhile, the production group (to -0.8% from 0.1), which includes manufacturing, contracted at its fastest pace since May 2017. The construction sector (2.1 from 1.6) continued to grow, after declining in the spring; growth in the agriculture sector (0.4 from 0.3) continues to hover around zero.

**UK Industrial Production** (link): November data show industrial output hasn’t posted a gain in three months, while manufacturing production fell for the fifth consecutive month. Headline production contracted -0.4% m/m and -1.5% during the three months through November. Meanwhile, manufacturing production fell -0.2% in November and -1.3% the past five months. Looking at the main industrial groupings, here’s a tally for November and the five months through November: Consumer nondurable (+1.1% & -2.7%), consumer durable (+0.4 & -1.7), capital (-0.4 & -1.2), and intermediate (-1.4 & -0.5) goods orders. December’s M-PMI saw a further modest improvement in the UK’s manufacturing sector, with the index climbing for the second month, from 51.1 in October to a six-month high of 54.2% in December. Still, the Q4 average of 53.0 was the weakest since Q3-2016. The increase in December’s M-PMI was mainly driven by the best growth in new orders in ten months, reflecting a strengthening in both the domestic and export markets—with the latter benefiting from improved demand from the US, Europe, China, India, Brazil, and Africa. According to the report, manufacturers linked increases in both domestic and overseas demand to “clients purchasing to build up safety stocks to mitigate potential Brexit disruption.”

**Spain Industrial Production** (link): Output contracted in November at its fastest pace since April, with all sub-sectors in the red. Production, excluding construction, fell -1.6% following a 1.1% increase and a -0.8% decrease the prior two months. It’s down -3.3% from its cyclical high at the end of 2017. Production in the main industrial groupings are down both monthly and ytd for: capital (-1.8% m/m & -
1.5% ytd), intermediate (-1.7 & -2.9), consumer durable (-1.7 & -4.5), and consumer nondurable (-1.0 & -0.7) goods. Meanwhile, Spain’s IHS Markit M-PMI fell for the second month in December to 51.1—its lowest reading since August 2016—from 52.6 in October; output and new orders advanced at their slowest rates in around two and a half years, though foreign sales held up well at the end of 2018.