MORNING BRIEFING
May 14, 2019

M*A*S*H

See the collection of the individual charts linked below.


Strategy: Panic Attack #63? M*A*S*H (an acronym for "Mobile Army Surgical Hospital") is an American war comedy-drama television series that aired on CBS from 1972 to 1983. Once again, investors are flocking back to the hospital seeking relief from the post-traumatic stress disorder they’ve suffered from since the financial crisis of 2008. Ever since then, they’ve experienced recurring panic attacks, fearing each time that another crisis is imminent. When nothing terrible happened, the panic attacks were followed by relief rallies.

Joe and I have kept a diary of these recurring events titled “S&P 500 Panic Attacks Since 2009.” By our count, there have been 63 such attacks since 2009 including the latest one. Six of them were full-fledged corrections, while the rest were mini-corrections (Fig. 1).

Our approach to identifying selloffs as panic attacks is totally subjective. We do so by associating them with news headlines that triggered them as investors were overcome with fear that the latest developments could trigger a recession. In the latest selloff, the S&P 500 is down 4.5% from a record high of 2945.83 on April 30 through yesterday’s close (Fig. 2). It remains 1.5% above its 200-day moving average (Fig. 3).

The latest panic attack was triggered at the beginning of last week when the Trump administration revealed that trade talks with China had hit a major roadblock (Fig. 4). That’s after weeks of assurances that progress was being made. The problem is that as soon as the deal was spelled out in a draft agreement, the Chinese came back with lots of revisions, which amounted to reneging on many of the principles that had been agreed to verbally.

The Chinese retaliated on Monday against Trump’s tariff of 25% on $200 billion of Chinese imports, which was raised from 10% on Friday. They imposed tariffs on $60 billion of US exports to China. Trump countered with a tweet accusing Chinese President Xi Jinping of reneging on the almost-done deal. He also ordered a tariff hike on almost all remaining imports—$300 billion worth from China. Trump accused China of playing for time in trade talks and warned he will offer a “far worse” deal if he wins next year’s presidential election.

In one of his tweets on Monday, Trump stated: “I say openly to President Xi & all of my many friends in China that China will be hurt very badly if you don’t make a deal because companies will be forced to leave China for other countries. Too expensive to buy in China. You had a great deal, almost
completed, & you backed out!"

A commentary in the ruling Communist Party’s People’s Daily on Monday countered: “At no time will China forfeit the country’s respect, and no one should expect China to swallow bitter fruit that harms its core interests.”

Of course, yesterday’s 2.4% drop in the S&P 500 wasn’t only about China. Consider the following when-it-rains-it-pours events:

(1) **Middle East.** Saudi Arabia said Monday two of its oil tankers were sabotaged off the coast of the United Arab Emirates (UAE) in attacks that caused “significant damage” to the vessels, one of them as it was on the way to pick up Saudi oil to take to the US.

The announcement by the Kingdom’s energy minister, Khalid al-Falih, came as the US issued a new warning to sailors and the UAE’s regional allies condemned the reported sabotage Sunday of four ships off the coast of the UAE port city of Fujairah.

The US has warned ships that “Iran or its proxies” could be targeting maritime traffic in the region. America is deploying an aircraft carrier and B-52 bombers to the Persian Gulf to counter alleged threats from Tehran.

(2) **Apple.** The stock prices of US companies that do business in China took big hits yesterday. Apple was down 5.8% on Monday. Also weighing on the stock was the following report from The Verge:

“The Supreme Court is letting an antitrust lawsuit against Apple proceed—and it’s rejected Apple’s argument that iOS App Store users aren’t really its customers. The Supreme Court upheld the Ninth Circuit Court of Appeals’ decision in Apple v. Pepper, agreeing in a 5-4 decision that Apple app buyers could sue the company for allegedly driving up prices. ‘Apple’s line-drawing does not make a lot of sense, other than as a way to gerrymander Apple out of this and similar lawsuits,’ wrote Justice Brett Kavanaugh.”

(3) **Yield curve.** Financial stocks were hard hit by the pancake-flattening of the yield curve. The spread between the 10-year US Treasury yield (at 2.40%) and the federal funds rate (at 2.375%) continued to narrow yesterday, falling to just 3bps (Fig. 5). The 2-year Treasury note yield fell to 2.18% yesterday, implying expectations of a Fed rate cut over the next 12 months (Fig. 6).

(4) **Sentiment.** While our approach to identifying panic attacks is subjective, we do pay attention to the S&P 500 VIX, which tends to spike during especially severe panic attacks (Fig. 7). It rose to 20.55 yesterday, the highest reading since the panic attack at the end of last year.

There’s a relatively close correlation between the VIX and the credit quality yield spread between the US high-yield corporate bond and the 10-year US Treasury bond (Fig. 8). The spread remained relatively low yesterday at 406bps.

Previously, we’ve argued that the Investors Intelligence Bull-Bear Ratio works better as a bullish contrary indicator when it is below 1.00 than as a bearish contrary indicator when it is above 3.00. However, the latest selloff coincided with a rebound in the ratio just above 3.00 at the end of April and early May, the highest readings since early October (Fig. 9). The latest panic attack may be exacerbated by too much bullish sentiment based on expectations of an imminent US-China trade deal stoked by the Trump administration’s cheerleading.
Commodities: Taking a Trade Hit. Contributing to the latest panic attack in the stock market is the weakness in commodity prices, which tend to be very sensitive indicators of global economic activity. Last week’s escalation of the trade war between the US and China put renewed downward pressure on commodity prices. Consider the following:

(1) The CRB raw industrials spot price index dropped on Friday to the lowest reading since November 1, 2016 (Fig. 10). The nearby futures price of copper, which is highly correlated with the China MSCI stock price index (in yuan), also declined last week, but it remains up 13.1% ytd through Monday (Fig. 11).

(2) Crude oil. Notwithstanding the renewed tensions in the Middle East, oil futures fell on Monday with stock prices, as worries about the US-China trade talks spooked investors who had sent oil higher in early trading on concerns that tanker attacks in the Middle East could disrupt supplies. Helping to cushion the supply-side of the oil market is that US oil field production is running around a record 12.0mbd recently, up from 10.6mbd and 9.2mbd a year ago and two years ago (Fig. 12).

(3) Soybeans. The nearby futures price of a bushel of soybeans dropped on Monday to the lowest since December 2008 (Fig. 13). This weakness has been widely attributed to reduced purchases by China of US soybeans in retaliation for the tariffs imposed by Trump. However, yesterday, we reviewed the deadly swine flu epidemic in China. The resulting plunge in China’s pig population is depressing the country’s demand for soybeans to feed the pigs.

(4) Lumber. Despite the drop in mortgage rates in the US, the nearby futures price of lumber has tumbled from a 2018 peak of $651 per 1,000 board feet on 5/14 to $339 on Monday (Fig. 14). Lumber prices typically rise in the spring as builders stock up for construction season. But this year, they are being hit hard by bad weather and a decline in home building.

(5) The dollar. Weighing on commodity prices is the renewed strength in the trade-weighted dollar. It is up 2.3% since the end of January (Fig. 15). As we observed yesterday, the recent escalation of trade tensions seems to be bullish for the dollar, which offsets some of the inflationary impact of higher tariffs. A strong dollar tends to depress commodity prices.

CALENDARS

US. Tues: NFIB Small Business Optimism Index 102.0, Import Prices Total & Ex Petroleum 0.7%/0.1%, Williams, George. Wed: Retail Sales Total, Ex Autos, Ex Autos & Gas, Control Group 0.2%/0.7%/0.4%/0.3%, Business Inventories 0.0%, Headline & Manufacturing Production 0.0%/0.1%, Capacity Utilization 78.7%, Empire State Manufacturing Index 8.0, NAHB Housing Market Index 64, MBA Mortgage Applications, Treasury International Capital, DOE Crude Oil Inventories, Quarles.(DailyFX estimates)

Global. Tues: Eurozone Industrial Production -0.3%m/ml/-0.8%y/y, Eurozone ZEW Survey, Germany ZEW Survey Current Situation & Expectations 6.0/5.0, Germany CPI 2.0% y/y, UK Employment Change & Unemployment Rate (3-month) 141k/3.9%, UK Average Weekly Earnings (3-month) 3.4% y/y, Australia Business Confidence. Wed: Eurozone GDP 0.4%q/q/1.2%y/y, Eurozone Employment, Germany GDP 0.4%q/q/0.7%y/y, Canada CPI 0.4%m/m/2.0%y/y, China Retail Sales 8.4% y/y, China Industrial Production 6.5% y/y, China Fixed Assets (ytd) 6.4% y/y, Coeure. (DailyFX estimates)
STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings (link): Forward earnings rose w/w for a fourth straight week for all of the market-cap indexes. LargeCap’s has risen during 10 of the past 13 weeks; MidCap’s in eight of the past nine weeks; and SmallCap’s in six of the past seven weeks. LargeCap’s forward EPS is just 0.6% below its record high of $175.48 in late October; MidCap’s is 0.9% below its mid-October high; and SmallCap’s is 6.2% below its mid-October high. At their bottoms, LargeCap’s forward EPS had been the most below its record high since June 2016, and MidCap’s was the lowest since May 2015. SmallCap’s had not been this far below since October 2010. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act, but tumbled as y/y comparisons became more difficult. But that may be ending soon too. In the latest week, the rate of change in LargeCap’s forward earnings fell to a 29-month low of 5.1% y/y from 5.2% y/y. That’s down from 23.2% in mid-September, which was the highest since January 2011 and compares to a six-year low of -1.8% in October 2015. MidCap’s y/y change dropped to 5.8% from 6.3%, which compares to 24.1% in mid-September (the highest since April 2011) and a six-year low of -1.3% in December 2015. SmallCap’s dropped to a 37-month low of 2.6% from 3.3%, which is down from an eight-year high of 35.3% in early October and compares to a six-year low of 0.3% in December 2015. Analysts had been expecting double-digit percentage earnings growth in 2019, but those forecasts are down substantially since October. Here are the latest consensus earnings growth rates for 2018, 2019, and 2020: LargeCap (22.7%, 3.3%, 11.7%), MidCap (22.7, 3.1, 13.5), and SmallCap (22.4, 4.4, 18.6).

S&P 500/400/600 Valuation (link): Forward P/E ratios fell w/w for all these indexes, but they remain well above their multi-year lows in late December. LargeCap’s weekly forward P/E fell to 16.5 from a 13-month high of 16.9, which is up from a five-year low of 13.9 during December. That compares to a 16-year high of 18.6 during January 2011 and of course is well below the tech-bubble record high of 25.7 in July 1999. Last week’s level remains above the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap’s forward P/E dropped 0.4pt to 15.7. That’s down from a seven-month high of 16.3 in early April, but up from 13.0 during December, which was the lowest reading since November 2011. MidCap’s P/E is down from a 15-year high of 19.2 in February 2017 and the record high of 20.6 in January 2002. However, MidCap’s P/E has been at or below LargeCap’s P/E for most of the time since August 2017—the first time that alignment has prevailed since 2009. SmallCap’s P/E weakened to 16.7 from 17.2, which is well above its seven-year low of 13.6 during December. That’s still well below its 51-week high of 16.3 in December, which was the lowest reading since November 2011. SmallCap’s P/E is down from a 15-year high of 19.2 in February 2017 and the record high of 20.6 in January 2002. However, MidCap’s P/E has been at or below LargeCap’s P/E for most of the time since August 2017—the first time that alignment has prevailed since 2009. SmallCap’s P/E weakened to 16.7 from 17.2, which is well above its seven-year low of 13.6 during December. That’s still well below its 51-week high of 20.2 in December 2017 (which wasn’t much below the 15-year high of 20.5 in December 2016, when Energy’s earnings were depressed). SmallCap’s P/E was higher than LargeCap’s P/E for a 15th straight week, after being below for much of December for the first time since 2003.

S&P 500 Sectors Quarterly Earnings Outlook (link): With the Q1 earnings season 90% complete, the blended Q1 estimate/actual surged in what has become the typical positive earnings surprise hook seen during the earnings seasons. Last week saw the S&P 500’s blended Q1-2019 EPS forecast rise yet another 16 cents w/w to $38.91. The $38.91 estimate represents a forecasted pro forma earnings gain for Q1-2019 of 1.3%, up from a forecasted decline of 2.3% in early April and a forecasted gain of 5.3% at the end of Q4. If it comes to pass, Q1’s gain would be its 11th straight y/y rise, but down from 16.8% in Q4 and 28.4% in Q3 (which marked the peak of the current earnings cycle). Just five of the 11 sectors are expected to record positive y/y earnings growth in Q1-2019, with only one rising at a double-digit percentage rate. That compares to 10 positive during Q4, when seven rose at a double-percentage rate. Five sectors are now expected to match or beat the S&P 500’s Q1 growth rate, which compares to just four during Q4. Real Estate and Utilities are the only sectors expected to post better growth on a q/q basis during Q1. Here are the latest forecasted Q1-2019 earnings growth rates versus their Q4-2018 growth rates: Health Care (10.1% in Q1-2019 versus 13.3% in Q4-2018), Financials (8.1, 15.6), Industrials (6.9, 27.0), Consumer Discretionary (7.4, 18.1), Real Estate (6.3, 6.2), Consumer Staples (-0.2, 4.6), Utilities (-0.5, -10.4), Information Technology (-2.1, 10.3), Communication Services
On an ex-Energy basis, analysts expect S&P 500 earnings to rise 2.7% y/y in Q1 compared to a 1.2% a week earlier. Still, that’s well below the 14.2% y/y gain in Q4 and the lowest ex-Energy growth rate since Q2-2016.

S&P 500 Q1 Earnings Season Monitor (link): With 90% of the S&P 500 companies finished reporting revenues and earnings for Q1-2019, the y/y growth rates in revenues and earnings have slowed substantially from Q4. The revenue surprise metrics have weakened substantially, but earnings continue to beat forecasts. Of the 450 companies in the S&P 500 that have reported through mid-day Wednesday, 76% exceeded industry analysts’ earnings estimates. Collectively, the reporters have averaged a y/y earnings gain of 3.0%, and exceeded forecasts by an average of 6.7%. On the revenue side, just 57% of companies beat their Q1 sales estimates so far, with results coming in 0.2% above forecast and 5.4% higher than a year earlier. Earnings growth is trailing revenue growth for the first time since H1-2016. Q1 earnings growth results are positive y/y for 64% of companies, vs a higher 72% at the same point in Q4, and Q1 revenues have risen y/y for 67% vs a higher 75% during Q4. These figures are not likely to change markedly as the remaining Q1-2019 results are reported in the coming weeks. Looking at earnings during the same point in the Q4-2018 reporting period, a lower percentage of companies (70%) in the S&P 500 had beaten consensus earnings estimates by a lower 3.5%, but earnings were up a higher 14.4% y/y. With respect to revenues at this point in the Q4 season, a higher 60% had exceeded revenue forecasts by a higher 0.6%, and sales rose a greater 5.9% y/y. The results so far for Q1 indicate a slowdown in revenue and earnings growth from Q4, but that comes as no surprise to investors. Q1-2018 will mark the 11th straight quarter of positive y/y earnings growth and the 12th for revenue growth. Looking at the Q1 results ex-Financials and Real Estate, the earnings surprise improves to 6.9% from 6.7% and growth falls to 2.1% from 3.0%. The ex-Financials and Real Estate revenue surprise of 0.2% and revenue growth of 5.4% both remain at the same rate as that with all sectors included.

GLOBAL ECONOMIC INDICATORS

UK Industrial Production (link): Output climbed for the third month in March, with manufacturing particularly strong, driven in part by firms stockpiling in preparation for a no-deal Brexit. This will likely depress demand going forward. Headline production increased 0.9% in March and 2.3% ytd to its highest reading since October 2008, with manufacturing production up 0.9% and 3.5%, respectively, over the same periods. Here’s a look at production gains among the main industrial groupings, over the same periods, for consumer nondurable (1.8% m/m & 6.4% ytd), consumer durable (0.5 & 4.1), capital (0.6 & 2.3), and intermediate (0.3 & 2.9) goods; energy output rose 0.2% in March and fell 1.3% ytd. Meanwhile, April’s M-PMI fell from a 13-month high of 55.1 in March to 53.1 last month, on weaker growth in production, new orders, and stocks of purchases. Output growth slowed from March’s 10-month high as rates of expansion eased sharply in the intermediate and investment goods sectors; there was a mild acceleration in consumer goods.

France Industrial Production (link): Output in March posted its largest decline since November, though production for the quarter improved from Q4’s slight contraction during the “yellow vest” crisis. Headline production, which excludes construction, sank 0.9% in March after a 1.6% gain during the two months through February, as manufacturing production dropped 1.0% after a two-month gain of 1.8%—expanding 1.1% during Q1 after a 0.1% downtick during Q4. Of the main industrial groups, investment goods continued to outperform the overall manufacturing sector—led by IT. Output for the group ticked down 0.3% during March, though expanded 3.1% ytd. Here’s a snapshot of the remaining industrial groups’ performances during the first three months of 2019: intermediate (1.6% ytd), consumer durable (0.6), and consumer nondurable (-3.4) goods production. Construction activity has been volatile so far this year, declining 0.9% during March after a 4.7% gain and a 3.9% loss during February and January, respectively, showing no change ytd. IHS Markit’s April report showed France’s M-PMI (to 50.0 from
49.7) climbed back up to the breakeven point of 50.0 after dipping below in February, pointing to a stabilization in business conditions across the French manufacturing sector.

**Italy Industrial Production** *(link)*: Production in March sank 0.9% after a two-month rebound of 2.6% from the 2.4% slide during the final three months of 2018. On a year-over-year basis, production turned negative again, down 1.4% y/y in March after swinging from a 5.7% y/y loss in December to a 0.9% gain in February. The biggest yearly decline in output was posted by energy (-5.9% y/y), followed by consumer durable (-2.4), intermediate (-1.9), and consumer nondurable (-0.7) goods; capital (1.2) goods production was above year-ago levels. In its April report, IHS Market reported Italy’s M-PMI (to 49.1 from 47.4) was below 50.0—the delineation between expansion and contraction—for the seventh consecutive month, though was nearing the breakeven point. According to the report, “New export orders expanded at the fastest pace since June 2018 and employment growth was at a six-month high. If the current trends for new business continue, the stage is set for a return to growth in output over the coming months.”

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