Slicing & Dicing Pork & Profits

See the collection of the individual charts linked below.

(1) Peace dividend likely for global economy. (2) A serious shortage of pigs in China. (3) Soaring meat prices inflating Chinese retail sales. (4) Chinese forward revenues and earnings remain subdued. (5) China MSCI is cheap and likely going higher. (6) What’s weighing on NIPA profits? (7) S corporations muddying the waters. (8) Dividend data suggest that underlying trend of profits is upward. (9) National Income shares can be misleading.

China: Pork Prices Boost Retail Sales. Yesterday, the financial press touted November’s 8.0% y/y increase in Chinese retail sales as a harbinger of better things to come for China’s economy in 2020. Trump’s willingness to deescalate his trade war with China following the Phase 1 trade deal announced at the end of last week also should boost China’s economy.

Melissa and I agree that reduced trade tensions with the US should benefit China, the US, and the rest of the world’s economy next year. However, we weren’t impressed by November’s retail sales report out of China.

As we observed just yesterday, the swine flu epidemic is decimating China’s pig population. Pork prices are soaring. That’s boosting nominal retail sales growth but depressing real growth in retail sales. Pork represents a big share of many Chinese consumers’ household budgets. Consider the following:

(1) Nominal vs real retail sales growth. While retail sales rose 8.0% y/y in nominal terms, China’s CPI rose 4.5% y/y. As a result, inflation-adjusted retail sales rose just 3.5%, the weakest pace since December 1997 (Fig. 1).

(2) Lots of food inflation. The CPI for meat, poultry, and related products soared 74.5% y/y through November (Fig. 2). The CPI excluding food was up just 1.0% over this same period (Fig. 3).

(3) Production growing. There was better news in November’s industrial production, which rose 6.2% y/y (Fig. 4). That’s better than the month before, but this growth rate has been hovering around 5.0% since the start of this year—near some of the lowest readings during the Global Financial Crisis.

(4) Less bang per yuan. According to the People’s Bank of China (PBOC), the outstanding amount of bank loans in China has increased six-fold, from $3.6 trillion at the start of 2008 to $21.7 trillion through November 2019 (Fig. 5). The PBOC has fueled this credit binge by lowering the reserve requirement ratios for large banks (as well as small/medium-sized ones) from a record high of 21.5% (19.5%) during H2-2011 to 13.0% (11.0%) during late September of this year (Fig. 6).

We like to monitor the ratio of industrial production to bank loans in China. It has dropped from a record high of 106.6 during December 2007 to only 50.7 last month (Fig. 7). The PBOC is getting less and less bang per yuan of bank lending!
Looking forward. Joe and I track the forward revenues and forward earnings of the China MSCI stock price index (Fig. 8 and Fig. 9). Both are uninspiring, having been on slight downward trends since early last year. The question is whether the easing of trade tensions with the US will revive these two sensitive economic indicators. We suspect that homegrown problems may also be weighing on China’s economy. These include too much debt and too many seniors.

Nevertheless, the consensus of industry analysts is that the revenues of the China MSCI will grow 8.9% this year, 8.9% next year, and 8.1% in 2021 (Fig. 10). They are expecting earnings to grow 22.1% this year, 12.3% next year, and 13.9% in 2021.

Consolidating to go higher. The China MSCI stock price index (in both yuan and US dollars) has traced a volatile triangular consolidation pattern since Trump started the trade war with China last spring (Fig. 11). They’re both up 21% since this year’s low on 1/3 through Friday’s close.

Our hunch is that the index goes higher in 2020 now that trade tensions are easing. Another positive is that the stock index is selling at a relatively cheap 11.3 forward P/E. (See our Global Index Briefing China MSCI.)

Corporate Profits: Dividends Confirming Profit’s Uptrend. Joe and I are seeing more and more articles on the discrepancy between the growth in after-tax corporate profits as measured in the National Income & Product Accounts (NIPA) and the growth in S&P 500 reported net income, which tends to account for about half of NIPA profits. The NIPA measure has been stalled at a record high around $1.9 trillion since Q1-2012 (Fig. 12). Meanwhile, S&P 500 reported net income remains on an uptrend in record-high territory.

The spread between these two measures has been on a downward trend since Q1-2012 (Fig. 13). The question is: What’s in the spread that has weighed on corporate profits, offsetting the uptrend in the S&P 500 net income? Consider the following:

(1) What’s in NIPA profits? According to the NIPA Handbook, corporate profits includes all US public, private, and “S” corporations. It also includes other organizations that do not file federal corporate tax returns—such as certain mutual financial institutions and cooperatives, nonprofits that primarily serve business, Federal Reserve banks, and federally sponsored credit agencies.

(2) What are S corporations? On its website, the IRS explains the difference between C and S corporations: “A C corporation is taxed on its earnings, and then the shareholder is taxed when earnings are distributed as dividends. S corporations elect to pass corporate income, losses, deductions and credits through to their shareholders for federal tax purposes. Shareholders of S corporations report the pass-through of income and losses on their personal tax returns and are assessed tax at their individual income tax rates. This allows S corporations to avoid double taxation on the corporate income.”

As a result, most of the income of S corporations is paid out as dividends. So their profits are taxed once as personal dividend income rather than as corporate profits. We are reaching out to the NIPA folks to determine whether more C corporations have elected to be S corporations, which might misleadingly depress NIPA after-tax profits.

(3) Accounting for dividends. Obviously, we’re still gathering up the pieces to this puzzle. There may be some clues in the data available for dividends. The Fed compiles a quarterly series for dividends paid by all corporations (Fig. 14). It closely tracks the monthly series for personal dividend income that is
included in personal income. We can derive a series that should be composed mostly of S corporation profits that are paid out as dividends by subtracting the dividends paid by S&P 500 corporations from the Fed’s series on dividends paid by all corporations (Fig. 15).

The important point is that dividends are at a record high for all three series. Since Q1-2012, when NIPA after-tax corporate profits first began to stall, total dividends are up 65%, S&P 500 dividends are up 92%, and the residual (which may include dividends paid mostly by S corporations) is up 54%. These figures suggest that the underlying profits must also have improved over this period.

(4) National Income shares must add up. The NIPA accounts distribute pre-tax National Income to the following categories: Compensation of Employees, Proprietors’ Income with inventory valuation and capital consumption adjustments (IVA and CCAdj), Rental Income of persons with CCAdj, Corporate Profits with IVA and CCAdj, Net Interest and miscellaneous payments, and three other minor categories. The adjustments are necessary because National Income shares, which sum to 100%, are based on income from current production.

Earlier this year, NIPA revisions contributed to the flattening of pre-tax profits from current production. The Q1-2019 level was cut by $245 billion to $2.0 trillion (saar) (Fig. 16). Offsetting this downward revision for Q1 were upward revisions for Compensation of Employees ($241 billion), Proprietor’s Income ($17 billion), and Net Interest ($103 billion) (Fig. 17).

So some of the recent flattening of NIPA profits reflects the upward revisions in compensation and interest expenses for corporate America. Labor’s share of Q1 National Income was revised up from 62.2% to 63.1%, while profits share was revised down from 12.6% to 11.2% (Fig. 18 and Fig. 19).

This measure probably understates labor’s share of income for a few reasons. For starters, compensation consists of the earnings of employees, but it does not include the earnings of the self-employed, which the NIPAs treat as proprietors’ income. Furthermore, S corporation dividends are more like labor compensation than profits, in our opinion.

(5) Bottom line. Our latest slice and dice of the NIPA profits data suggests that it’s a confusing measure of profits. What we do know is that S&P 500 net income continues to grow and so do dividends. The bull market’s fundamentals remain bullish, in our opinion.

CALENDARS

US. Tues: Headline & Manufacturing Industrial Production 0.8%/0.8%, Capacity Utilization 77.4%, Housing Starts & Building Permits 1.340mu/1.405mu, Job Openings 7.018m, Williams, Rosengren, Kaplan. Wed: MBA Mortgage Applications, DOE Crude Oil Inventoried, Brainard, Evans. (DailyFX estimates)

Global. Tues: Eurozone Trade Balance, Eurozone Car Registrations, UK Employment Change & Unemployment Rate (3-month) -24k/3.9%, Carney, Lane. Wed: Eurozone Headline & Core CPI 1.0%/1.3% y/y, Germany Ifo Business Climate, Current Assessment, and Expectations Indexes 95.5/98.1/93.0, UK Headline & Core CPI 1.4%/1.7% y/y, Australia Employment Change & Unemployment Rate 15k/5.3%, BOJ Rate Decision, Lagarde. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings (link): The forward earnings of MidCap and SmallCap rose for a fourth week in a row, and LargeCap’s was up for a third after dropping a week earlier. These indexes
began a forward-earnings uptrend during March, but stumbled from July to November. LargeCap’s forward earnings has risen during 31 of the past 44 weeks, MidCap’s 23 of the past 40 weeks, and SmallCap’s 21 of the past 38 weeks. LargeCap’s is just 0.2% below its record high 13 weeks ago, while MidCap’s and SmallCap’s are 5.0% and 8.3% below their October 2018 highs. MidCap’s forward earnings is improving now from November’s 18-month low, while SmallCap’s is up from September’s 17-month low. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act but began to tumble in October as y/y comparisons became more difficult. In the latest week, the rate of change in LargeCap’s forward earnings rose to 1.3% y/y from a 38-month low of 1.0%. That’s down from 23.2% in September 2018, which was the highest since January 2011. MidCap’s was up w/w to -4.6% y/y from -5.3%, and compares to -5.5% in mid-November, which was the lowest since December 2009. That also compares to 24.1% in September 2018 (the highest since April 2011). SmallCap’s -5.5% y/y change was up w/w from -7.0% and from -9.6% in mid-September, which was the lowest since December 2009 and compares to an eight-year high of 35.3% in October 2018. Analysts had been expecting double-digit percentage earnings growth for 2019 last October, but those forecasts are down substantially since then. Here are the latest consensus earnings growth rates for 2018, 2019, and 2020: LargeCap (22.7%, 0.1%, 9.8%), MidCap (22.7, -7.2, 12.2), and SmallCap (22.4, -19.8, 37.2).

S&P 500/400/600 Valuation (link): LargeCap’s valuation rose for the ninth week in ten, but the SMidCap indexes were flat or slightly lower. However, they’re all at or near their highest levels in over a year. LargeCap’s forward P/E rose 0.1pt w/w to a 23-month high of 17.9 from 17.8. That compares to a five-year low of 13.9 during December 2018 and a 16-year high of 18.6 during January 2018—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 was steady w/w at a 21-month high of 17.1. That’s up from 13.0 during December 2018, 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 edged down 0.1pt, to 17.8 from a 14-month high of 17.9. That’s well above its seven-year low of 13.6 during December 2018 and compares to its 15-year high of 20.5 in December 2016, when Energy’s earnings were depressed. SmallCap’s P/E was a tad below LargeCap’s again. It had been below for four months through the end of August—the first time that has happened since 2003.

S&P 500 Sectors Quarterly Earnings Outlook (link): With two weeks to go before the end of Q4, earnings revisions activity has entered its typical slow period. The Q4 EPS forecast dropped just 4 cents w/w to $40.74. That represents a decline of 1.1% on a frozen actual basis and a drop of 0.2% y/y on a pro forma basis. That compares to a 0.4% decline in Q3 and y/y gains of 3.2% in Q2, 1.6% in Q1, 16.9% in Q4-2018, and 28.4% in Q3-2018 (which marked the peak of the current earnings cycle). If the y/y earnings decline comes to pass in Q4-2019, it would be the second straight decline and the first drop since earnings fell y/y for four straight quarters through Q2-2016. However, seven of the 11 sectors are expected to record positive y/y earnings growth in Q4, with two rising at a double-digit percentage rate. That compares to seven positive during Q3, when none rose at a double-digit percentage rate. The same seven sectors are expected to beat the S&P 500’s 0.2% decline in Q4 as in Q3; that’s up sharply from just three beating the S&P 500 during Q2. Six sectors are expected to post improved growth on a q/q basis during Q4: Communication Services, Energy, Financials, Materials, Tech, and Utilities. On an ex-Energy basis, the consensus expects earnings to rise 2.0% y/y in Q4. That compares to ex-Energy gains of 2.2% in Q3, 3.9% in Q2, and 3.0% in Q1. However, that’s well below the 25.0% and 14.2% y/y gains in Q3- and Q4-2018, respectively. Here are the latest Q4-2019 earnings growth rates versus their nearly final Q3-2019 growth rates: Utilities (14.6% in Q4-2019 versus 6.7% in Q3-2019), Financials (12.5, 2.5), Health Care (6.1, 8.8), Real Estate (3.8, 5.6), Communication Services (1.8, -1.5), Consumer Staples (0.6, 3.7), Information Technology (0.4, -1.7), Industrials (-5.4,
3.4), Materials (-9.6, -11.0), Consumer Discretionary (-12.0, 1.8), and Energy (-34.4, -37.8).

**US ECONOMIC INDICATORS**

**Regional M-PMI (link):** The New York Fed—the first district to report on manufacturing activity for December—showed activity held fairly steady at a sluggish pace, remaining just above zero for the sixth month. The composite index ticked up to 3.5 in December from 2.9 in November—averaging 3.6 per month the last half of the year. New orders (to 2.6 from 5.5) expanded at a slightly slower pace than in November, while shipments (11.9 from 8.8) grew at a slightly faster pace—increasing at more than quadruple the rate of orders. The unfilled orders index (-13.8 from -8.2) contracted at a faster pace this month, while delivery times (-5.8 from -5.5) shortened slightly and inventories (2.2 from -6.2) held steady, after contracting in November. Employment (unchanged at 10.4) continued to expand at a solid rate after falling during the summer months. Meanwhile, the average workweek (0.8 from 2.3) was unchanged. The input price (15.2 from 20.5) eased for the third month, down from its recent peak of 54.0 last May, while selling prices (4.3 from 6.2) rose at roughly one-fifth the pace of its recent peak of 22.9 near the start of the year. Optimism about the six-month outlook continued to improve, rising for the third month from 13.7 in September to 29.8 this month—with capital-spending plans soaring from 4.6 to 26.1 over the three-month span.

**GLOBAL ECONOMIC INDICATORS**

**US PMI Flash Estimates (link):** Business activity this month expanded at its fastest pace in five months, according to flash estimates, driven by an acceleration in services activity—though manufacturing activity held around seven-month highs. December’s C-PMI improved for the second month, from 50.9 in October to 52.2 this month, with the NM-PMI increasing from 50.6 to 52.2 over the two-month period, to its best reading since July. The M-PMI took a negligible step back this month, to 52.5, after accelerating from 50.3 in August to a seven-month high of 52.6 in November. According to the report, while the increase in new business in the service sector remained historically muted, the rate of expansion accelerated, with companies reporting the fastest rate of new orders growth in five months. Firms also registered a renewed rise in export orders at the end of 2019, following four consecutive monthly declines. Expectations among service providers climbed to a six-month high. Meanwhile, the manufacturing sector was supported by a further expansion in both output and new orders, with the upturn in the latter remaining solid overall. While rates of increase eased in each case, growth remained more robust than it was earlier this year.

**Eurozone PMI Flash Estimates (link):** “Eurozone malaise extends in December, ending worst quarter since 2013” is the headline of this month’s IHS Markit’s flash estimate report. The C-PMI flash estimate was unchanged at November’s 50.6 this month, not far from September’s 50.1 which was the second-smallest expansion of output across manufacturing and services since the current upturn began in July 2013. “The economy has been stuck in crawler gear for [the] fourth straight month, with the PMI indicative of GDP growing at a quarterly rate of just 0.1%,” according to Chris Williamson, chief business economist at IHS Markit. The NM-PMI rose to a four-month high of 52.4 this month, up from a recent low of 51.6 in September, while the M-PMI sank to 45.9, contracting for the 11th straight month as the output index fell to an 86-month low. Looking at the top two Eurozone economies, France continued to outpace Germany, with the latter stuck in a mild downturn amid a deepening manufacturing recession. Flash estimates show France’s C-PMI (to 52.0 from 52.1) dipped to a three-month low this month, while Germany’s was unchanged at 49.4—just below the breakeven point between expansion and contraction. NM-PMIs for both France (52.4 from 52.2) and Germany (52.0 from 51.7) improved to their best readings in two months and four months, respectively. Meanwhile, both saw their M-PMIs move lower, France’s (50.3 from 51.7) to a three-month low and Germany’s (43.4 from 44.1) to a two-month low. Outside of Germany and France, the rest of the Eurozone
reported output growth that matched November’s—which had been the slowest in six years. Meanwhile, manufacturing output contracted at its sharpest pace since March 2013—countered by the largest monthly rise in service-sector activity since March.

**Japan PMI Flash Estimates** ([link](#)): Japan’s activity this month was broadly stagnant once again, according to flash estimates, showing little rebound from October’s sharp drop—which was impacted by a one-two punch from a sales tax hike and a typhoon. October’s C-PMI (to 49.1 from 51.5) contracted for the first time since September 2016; December’s C-PMI was below the breakeven point of 50.0 for the third month, holding at November’s 49.8. The NM-PMI rebounded for the second month to 50.6 this month after falling in October (to 49.7 from 52.8). The M-PMI (48.8 from 48.9) was below 50.0 for the eighth straight month and the tenth this year. According to the report, “It is now clear that the service sector is unable to offset the industrial weakness, which does not bode well for growth prospects in 2020.” There’s some hope, however, that the recent stimulus package will breathe life back into the domestic economy.

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