MAJOR TOPICS: Turkeys, Ducks, Bulls, and Bears.

BULLET POINTS: (1) Not much peace and harmony after Thanksgiving. (2) The Chinese have to muzzle Little Kim. (3) The Europeans are stuck with each other. (4) Are channel checks illegal? (5) Coming in 2013: The European Stabilization Mechanism. (6) If all else fails, will ECB go down QE road? (7) Consumer Discretionary is leading the packs. (8) Profitable companies have always created jobs, and are doing it again. (9) Did the Fed overreact? (10) Jobless claims getting closer to 399,999. (11) Record high for Consumer Discretionary forward earnings. Also for Consumer Staples, Health Care, and IT. (12) Good deflation associated with productivity, prosperity, and profitability.

NOTICE: Our Morning Briefings are now available on FactSet.

I) HOT BUTTONS: Welcome back. I hope you enjoyed a long and relaxing Thanksgiving holiday weekend with lots of dinner plates full of turkey and stuffing around your dining room table for all your family and friends to enjoy in peace and harmony. This morning, it is time to get stressed out again. There isn’t much peace and harmony in the world today. On our breakfast plates are several stomach-churning issues, including the Korean War II, the European sovereign debt crisis, an insider trading scandal in the US, a lame-duck session of Congress, and QE gone wild in China and the US.

It is enough to turn a bull into a bear, or at least into a turkey dreading the approach of Thanksgiving Day. To avoid the turkey’s fate, should we now join the bears in their tug of war with the bulls after having pulled for the bulls since March 2009? I’m not ready to do so, though I readily admit that much has to go right for those of us who choose to stay the bullish course over what’s left of the year and early next year. Here is my positive spin on the latest hot-button issues:

(1) The Chinese may have to put a muzzle on their North Korean pit bull. Or, at the very least, they will have to broker a more specific list of ground rules to avoid further violations of the truce ending the Korean War I, so that it doesn’t turn into Korean War II.

(2) I expect that the Europeans will increase the size of their bailout fund, if necessary. More importantly, the ECB may be forced to follow the Fed down the path of massive quantitative easing by purchasing lots of European sovereign debt, if necessary.

(3) As for trading on inside information, I am against it, though I’m not sure that “channel checks” constitute such illegal activities. So until I know more about the alleged
widespread scandal uncovered by Manhattan’s prosecutor, I’ll suspend judgment on the likely impact on the market.

(4) Meanwhile, down in DC, there is no way that the lame ducks have enough time or the will to tackle all the issues put on their plates by the lame leadership of the Democrats. However, in my opinion, neither Democrats nor Republicans will risk infuriating voters by failing to extend the Bush tax cuts and to approve funding for the government.

Let’s have a closer look at the first and the second of these hot-button issues:

The Chinese need to do something about North Korea. It is widely believed that they’ve supported the Stalinist regime of Kim Jong-il because they fear that millions of starving North Koreans will flood into their country if his regime fails. More likely they fear that a reunited Korea, following such a collapse, would be led by South Koreans and would be an ally of the United States. They certainly aren’t happy about seeing American war ships cruising around their neighborhood in response to the North’s latest military provocations of the South. On Sunday, China called for an emergency international meeting to ease tensions on the Korean peninsula, following a rare burst of shuttle diplomacy by the Chinese, who finally seem to be responding to accusations that they have failed to rein in their North Korean ally.

Axel Weber heads Germany’s Bundesbank, and he is a member of the ECB’s Governing Council. He may also be the next president of the ECB, when Jean Claude-Trichet’s term ends next October. So it was noteworthy when the fiscally conservative central banker noted last week that the EU’s bailout fund could be increased if necessary to restore confidence in the euro. In a worst-case scenario, the fund would need an additional 140bn euros ($187bn), an amount that would not jeopardize the survival of the euro, he said in Berlin. The German government immediately shot down the idea. However, if the latest actions agreed to by the EU over the weekend to avert a financial contagion don’t work, I bet that Weber along with his colleagues at the ECB would vote to purchase the sovereign debt of financially challenged governments in Europe. QE for PIIGS.

Over the weekend, the Europeans agreed on the details of a bailout for Ireland. They also agreed to set up a European Stabilization Mechanism after 2013 to replace the bailout fund they established during May. A central element of the plan is that future debt crises in Eurozone member states would be dealt with on a case-by-case basis, rather than according to any automatic mechanism.

II) STRATEGY: It seems as though just about everyone has been down on the US economy, in general, and the US consumer, in particular. It has been all too easy to curb one’s enthusiasm for the two given the severity of the unemployment situation in America. Which of course explains why the Consumer Discretionary sector has been the best performing sector in the stock market across all three market capitalizations (LargeCap, MidCap, and SmallCap) so far this year! Go figure! The stock market is telling us that the US economy, in general, and the US consumer, in particular, are in better shape than widely perceived. Debbie and I have been making the same point, as reviewed below.
On a ytd basis, the S&P 1500’s Consumer Discretionary sector is up 22.9% with LargeCaps up 21.9%, MidCaps up 27.5%, and SmallCaps up 29.8%. All four readings put them in first place in their respective sector derbies. The S&P 500 Consumer Discretionary Retail Index is up 20.4% ytd. It has been a back-to-school outperformer, rising 24.8% since the end of August vs. the S&P 500’s gain of 13.3% over the same period.

Joe and I expect that Consumer Discretionary, in general, and Retailers, in particular, may continue to outperform for a while longer. That’s because there continues to be widespread pessimism about American consumers, who are nevertheless likely to continue doing what they do best. They’ve been able to do so because the Haves have jobs, and their average real income is at a record high. The Have-Not’s don’t have jobs and may be about to lose their long-term unemployment benefits. However, the employment situation may be improving, as discussed below. Contrary to the fears of our fearless Fed Chairman about deflation, all consumers have been enjoying the benefits of near zero inflation.

* S&P 1500/500/400/600 Performance (weekly): How did the S&P indexes do last week? LargeCap fell 0.9%, but MidCap (1.1) and SmallCap (1.8) both rose. Nineteen of the 30 sectors rose last week, but just 3/30 sectors are negative ytd. All 10 SmallCap sectors and seven of the 10 MidCap sectors were higher last week, but just two of the 10 LargeCap sectors rose. S&P 1500 Consumer Discretionary and Tech rose 0.8% and 0.6%, respectively, as all their market-cap groups moved higher. SmallCap Telecom, LargeCap Health Care, and Utilities are the only sectors still down so far in 2010. MidCap is still the best performer ytd, with a gain of 18.3%, followed by SmallCap (17.2) and then LargeCap (6.7). Consumer Discretionary is the best performing S&P 1500 sector ytd, with a gain of 22.9%, followed by Industrials (16.1), Materials (10.0), and Energy (8.8). Health Care (-0.5) is the worst performer ytd, followed by Utilities (0.3), Financials (1.5), Telecom (5.3), Tech (7.5), and Consumer Staples (7.9). S&P 1500 Financials was the worst performer again last week, as it fell 2.2% and has fallen in five of the past seven weeks.

* S&P 500 Sectors and Industries Performance (weekly): How did the S&P 500’s sectors and industries perform last week? The S&P 500 fell 0.9%, but is up in nine of the past 12 weeks. Just two of the 10 sectors rose last week, and the S&P 500 is now down 3.0% from its bull market high on November 5. Seven of the 10 sectors and 99/130 industries are up so far in Q4, and eight of the 10 sectors and 96/130 industries are positive in 2010. Five of the 10 sectors are now beating the S&P 500’s ytd gain of 6.7%, up from just three sectors beating the S&P 500 three weeks ago. The best performers: Consumer Discretionary (up 21.9%), Industrials (15.6), Materials (8.3), Energy (8.0), and Consumer Staples (7.4). Health Care (-2.4) and Utilities (-1.4) are the worst performers ytd, and are also among the three worst performers so far in November and Q4. Energy is best performer so far in November and in Q4, and has improved to third best ytd from seventh just three weeks ago.

III) US ECONOMY: Let’s repeat the following mantra over and over again until they start to chant it at the White House, in Congress, and on the FOMC: Profitable companies create jobs. Debbie and I have been repeating this mantra for a while. In the spirit of John Lennon, all we are saying is give profits a chance to revive the labor markets. This scenario seems to be unfolding right now.
Fiscally profligate politicians create huge budget deficits, not jobs, as demonstrated yet again by the lackluster recovery in the jobs market despite the huge fiscal stimulus package passed by Congress during February 2009. It mostly postponed the firing of state and local employees, who are now losing their jobs as the federal funds run out.

If Fed officials had more confidence in the power of profitable companies to create jobs, they would have been more patient rather than rushing to implement QE-2.0. Apparently, Fed Chairman Ben Bernanke doesn’t share our faith in private enterprise. In his recent speech on October 19 in Frankfurt, he explained why he pushed for a second round of QE: “In sum, on its current economic trajectory the United States runs the risk of seeing millions of workers unemployed or underemployed for many years. As a society, we should find that outcome unacceptable.”

Wouldn’t it be great if the US labor market is starting to recover surprisingly well, confirming that the Fed overreacted by launching QE-2.0? That’s what Debbie and I think may be happening. If so, then the Fed will be forced to curtail its purchases of Treasury securities, especially once three nonvoting dissidents on the FOMC get to vote next year starting with their meeting on January 25-26, 2011. Debbie and I are encouraged by the following recent developments:

(1) Jobless claims down. Initial unemployment claims fell 34,000 to 407,000 during the week ending November 20. They are down to the lowest reading since the week ending July 10, 2008. The four-week average is down to 436,000, the lowest since the week ending August 9, 2008. After the congressional regime change on November 2, we concluded that the election results significantly reduced the regulatory uncertainty that was restraining profitable businesses from hiring workers. We predicted that jobless claims would soon fall to 399,999 and lower, i.e., below the 400,000 that demarcates a weakening or strengthening labor market.

(2) Personal income up. Personal income rose 0.5% during October, led by a 0.5% gain in earned income, which includes wages, salaries, and benefits. (Wages and salaries rose 0.6%, while benefits rose 0.3%.) Labor compensation, as measured in the GDP accounts, was revised upwards during Q3 by $63.5bn to $8,032.4bn (saar).

(3) Corporate profits and margins soaring. According to the latest GDP accounts, corporate profits rose to a record high of $1,427.1bn (saar) during Q3. As a result, a new all-time high was also set by corporate cash flow at $1,503.8bn during the quarter. Profits of nonfinancial corporations (NFCs) also rose to a record high during Q3. In the GDP accounts, the corporate profit margin was at 14.9%, little changed from Q2’s record high 15.0%. The NFCs’ margin remained at 8.7% last quarter, the best since the end of 2006. Repeat after me: Profitable companies hire workers.

(4) Productivity and pay at record highs. The strong profitability of US companies is partly attributable to their record productivity. Productivity is the key driver of inflation-adjusted earnings per worker. So while the miserable unemployment situation has grabbed all the headlines, the rise of real pay per worker has been woefully under reported. Debbie and I compute this number every month when personal income data are released. We divide wages, salaries, and benefits by payroll employment. In October, it
rose to a record $61,977 in current dollars. Adjusted for inflation using the personal consumption deflator, it rose to a record $55,585, up 1.5% y/y.

This will be a big week for learning whether the recent drop in jobless claims is confirmed by numerous other indicators of the labor market, including November’s PMI survey of manufacturing employment and ADP payrolls. Both will be released on Wednesday, followed by initial jobless claims on Thursday. Friday will start with November’s monthly employment report, along with the PMI non-manufacturing employment. Debbie and I expect 150,000 in payrolls with upward revisions again to the previous two months.

* GDP (Q3 Revision): What’s ahead for the US economy? Probably more of the same. Real GDP expanded at a revised 2.5% annual rate last quarter, stronger than the 2.0% preliminary gain. That’s up from 1.7% during Q2 but less than half the 5.0% pace recorded at the end of last year. Economic growth will likely remain subdued, at around 2.0%-2.5% at least through the first half of next year. The past two recoveries were described as “jobless,” evolving into full-fledged economic expansions only when employment picked up. The job market is showing signs of improvement.

* Contributions to GDP Growth: Which components were the biggest contributors to growth last quarter? Consumer spending and nonfarm inventory investment finished first and second. Real PCE contributed 1.97pps, with all the components adding to growth: services (+1.16pps), durables (+0.53pps), and nondurables (+0.28pps). Real nonfarm inventory investment accounted for 1.38pps, with farm subtracting 0.08pps. Real nonresidential fixed investment contributed 0.96pps, with spending on equipment and software accounting for 1.11 pps, and structures subtracting 0.15pps. Government spending added 0.81pps to Q3 real GDP, with federal spending contributing 0.71pps and state and local 0.10pps. Net exports of goods and services was the biggest drag on growth, subtracting 1.76pps from Q3 GDP, with imports subtracting 2.52pps and exports adding 0.77pps. Real residential investment also was a negative contributor to Q3 growth, subtracting 0.75pps, after adding to growth during Q2.

* Corporate Profits (Q3): What’s the latest trend in GDP profits? They are still climbing, and so is cash flow. After-tax profits, based on tax returns, increased for the seventh straight quarter during Q3, soaring 122.5% over the time period to a new record high. Profits from current production (“cash” profits) also rose for the seventh straight quarter, up 57.7% over the span, surpassing its Q3-2006 record high. Cash flow from current production increased for the eighth time in nine quarters to a new record high. Last quarter, pre-tax profits from current production accounted for 12.9% of National Income, above Q4-2008’s 22-year low of 8.1%, and below Q3-2006’s near record high of 13.7%. After-tax nonfinancial corporate profit rose from 7.0% to 8.7% from Q2-2009 to Q2-2010, moving out of recent flat trend. It remained at 8.7% during Q3, near Q3-2006’s cyclical peak of 9.7%. It coincides with the capacity utilization rate, which is increasing slowly from June’s record low of 68.3%.

* Profits from Abroad and of Domestic Nonfinancial & Financial Corporations: How important are overseas profits receipts to overall profits? They accounted for 34.2% of the total during Q3, down from a record high 50.1% at the end of 2008. Receipts from overseas rose 16.4% y/y, slowing from 25.3% at the start of the year. They posted a record 24.7% drop during Q2-2009. Overall domestic profits rose 36.6% y/y last quarter, slowing from 65.9% during Q4-2009. A 609.8% y/y surge in financial profits at the end of last year boosted y/y growth in domestic profits, which slowed as the financial profits growth rate dropped to 28.5% y/y last quarter. The growth rate of foreign profits of US
corporations is highly correlated with the growth of OECD industrial production and US exports, which are growing briskly. It is inversely correlated with the trade-weighted dollar, which remains weak.

* Personal Income & Spending: How are consumers’ vital signs? They improved in October, with income and spending growth accelerating. Personal income rose 0.5% in October, following no change in September, which was first reported as a 0.1% decline. Wages and salaries posted its strongest month since May, climbing 0.6%, while disposable income recovered 0.4% after falling slightly in September. Real earned income per worker (including wages, salaries, and benefits) advanced for the seventh straight month in October, based on 3-ma, to a new record high. It’s 3.7% above its recent low recorded in August 2008. Consumer spending increased 0.4% last month, following a 0.3% increase in September and gains of 0.5% in both August and July. Adjusted for inflation, spending grew 3.0% (saar) in the 3 months ending October, the fastest since the early months of 2007. Consumers were able to increase savings last month while maintaining solid spending growth. The key determinants of consumer spending are jobs and real pay per worker. We expect the spending recovery to be subpar given the high levels of unemployment. Solid productivity growth should continue to drive real pay per worker higher.

* Consumer Inflation: How’s inflation? Historically low. The core personal consumption expenditures deflator (PCED) was flat for the second straight month in October, following gains of 0.1% in each of the previous four months. It was up 0.9% y/y, the lowest on record going back to 1960! PCED rose only 0.4% (saar) during the three months ending October, with non-energy goods prices down 0.2% and non-energy services prices up 1.1%. Core CPI was flat in October for the third straight month. It has shown little change since the beginning of the year when it posted its first m/m decline since 1982. The y/y rate fell to 0.6%, the smallest gain ever recorded! The 3-month rate slowed to 0.2% (saar) last month from a 1.6% gain in July. It posted its first negative reading since 1960 in March.

* Consumer Monitor (weekly): What’s the Consumer Score? We’re keeping our rating at 52 this week, raising our rating on the mortgage applications for new purchase index a point and lowering our rating on weekly chain store sales a point. The former climbed for the fourth time in five weeks for a total gain of 20.8%. The latter slipped for the second straight week, failing to follow through on the strong start at the beginning of the month. Jobless claims dropped to lowest level since July 2008, though the decline was likely exaggerated by seasonal noise. The total number of people collecting unemployment insurance dropped to a two-year low during the latest reporting week, while those receiving extended benefits remains volatile w/w. Home equity loans still around record highs. Gasoline usage is drifting higher. The S&P 500 Retail Index rallies back near its recent high, 12.3% above its 200-dma. S&P 500 Restaurant Index remains around record high, 13.2% above its rising 200-dma. (Score for Restaurant Index already at 5/5.)

IV) EARNINGS MONTH: The main reason that Consumer Discretionary stocks have performed so well this year, as discussed above, is that they’ve had a remarkable rebound in their forward earnings over the past 19 months through November. Over this period, the forward earnings of the S&P 500’s Consumer Discretionary sector is up 258% to a new record high.

It has been a remarkable V-shaped recovery for this sector given the challenges of high unemployment and the lack of pricing power. Indeed, many companies in this sector have
had to lower their prices to attract consumers. The mantra of companies catering to consumers is “Discount and they will come.”

Their experience strongly suggests that contrary to the fears at the Fed about deflation, it actually stimulates consumer spending. But how can it simultaneously boost the profits of companies that are lowering their prices? The only way this can happen is through productivity. In other words, deflation attributable to productivity is consistent with prosperity and profitability!

* S&P 500 Aggregate Forward Earnings & Sector Shares (November): How did forward earnings (in billion dollars) perform for the S&P 500 and its 10 sectors in November? Eight of the 10 sectors rose m/m in November, the same as in September and October, but down from 10/10 in August. The S&P 500 increased 1.7% m/m and was up for a nineteenth straight month after 10 declines in a row through April 2009. Industrials ($83bn) led the pack with a 3.4% m/m gain, ahead of Consumer Discretionary ($81bn, 2.7%), Materials ($28bn, 2.1%), and Tech ($158bn, 2.1%). Tech ($154bn) is leading the pack with 20 monthly gains in a row. Forward earnings at a record high for three sectors: Consumer Discretionary ($81bn), Health Care ($112bn), and Tech ($158bn). Tech’s market share (19.0%) and earnings share (18.5%) are the highest in the S&P 500, but its earnings share is down slightly from a record high July. Earnings share for Industrials (9.8%) up from a record low of 8.9% in March. Health Care’s earnings share (13.2%) down from a record high of 19.2% in May 2009, and its 11.3% market share is down from a record high of 16.8% in February 2009. Telecom’s earnings share (2.6%) was at a record low again in November, but its market share was up to 3.1% from a record low of 2.7% in April. Financials’ earnings share (17.4%) at a 30-month high, and Consumer Discretionary (9.5%) at a 58-month high. Earnings share at a 25-month low for Health Care (13.2%) and Consumer Staples (10.1%), and dropped to a 26-month low for Utilities (3.6%).

* S&P 500 Absolute & Relative Valuations (November): Which S&P 500 sectors traded at premiums to the market in November? Six of the 10 sectors were at premiums to the S&P 500 in November, the same as from June to October. Tech at a slight premium to the market again after trading at a discount in August for the first time since January 1996. The S&P 500 P/E fell to 12.5 from 12.7 and is down from a 27-month high of 15.1 in September 2009, but is up from an 18-month low of 12.0 in August. The biggest premiums: Telecom (P/E of 15.1, 20.3% premium), Consumer Discretionary (14.2, 11.6%), Consumer Staples (13.8, 10.1%), Industrials (13.8, 10.1%), Materials (13.5, 7.7%), and Tech (12.9, 2.5%). Sectors at a discount in November: Health Care (P/E of 10.7, -14.6% discount), Financials (11.1, -11.3%), Energy (11.9, -4.9%), and Utilities (12.2, -2.4%). Financials up from an average 25.9% discount in the past, but mostly at an unusual premium since April 2009. Industrials down from a record high 18% premium to the market in April. Health Care up from a record low 24% discount in April 2009, but among the lowest in the S&P 500 since March 2009. Telecom’s premium near a five-year high, and Consumer Staples is near a two-year high.

in 2011. Telecom expected to be flat in 2010, and lower earnings expected for Utilities in 2011. Higher earnings expected for 113/126 industries in 2010 and 115/127 industries in 2011, up substantially from 31/131 industries with higher y/y earnings in 2009. Expected earnings growth for 2010 improved for 9/10 sectors in November, and 3/10 sectors had their 2011 growth forecast edge higher. The 2010 earnings growth forecast rose for Utilities (from 2.5% to 3.6%), Health Care (from 7.7% to 9.2%), Financials (from 215.8% to 243.1%), Industrials (from 22.0% to 23.5%), and Tech (from 44.8% to 46.9%).


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